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FOREIGN SALES CORPORATION ACT

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

S. 1804

FEBRUARY 3, 1984

Part 2 of 2

Printed for the use of the Committee on Finance

33-890 O

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1984

S361-49

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FOREIGN SALES CORPORATION ACT

FRIDAY, FEBRUARY 3, 1984

U.S. Senate,
Committee on Finance,
Washington, D.C.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. John C. Danforth presiding.

Present: Senators Dole, Danforth, Chafee, Heinz, Symms, Grassley, and Boren.

[The press release announcing the hearing, description of S. 1804 (Foreign Sales, Corporation Act) by the Joint Committee on Taxation, and the statements of Senators Symms, Grassley, and Boren follow:]

[Press release No. 83-207, Dec. 23, 1983]

FOREIGN SALES CORPORATION ACT

Senator Robert J. Dole (R., Kans.), Chairman of the Committee on Finance, announced today that a hearing will be held on Friday, February 3, 1984, on S. 1804, the Foreign Sales Corporation Act of 1983.

The hearing will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

Senator Dole noted that a previous hearing on S. 1804 on November 18, 1983, was shortened due to the press of other Committee business. Accordingly, the hearing on February 3, 1984, will be the first full opportunity to receive testimony.

DESCRIPTION OF S. 1804
(FOREIGN SALES CORPORATION ACT)

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON NOVEMBER 18, 1983

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on S. 1804 (Foreign Sales Corporation Act of 1983) on November 18, 1983. S. 1804 (introduced by Senators Dole, Boren, and Symms) embodies the Administration's proposed replacement of current tax code provisions relating to Domestic International Sales Corporations (DISCs) with Foreign Sales Corporations (FSCs).

The first part of the pamphlet is a summary. The second part is a discussion of background and present law regarding the DISC tax provisions and the GATT (General Agreement on Tariffs and Trade). The third part is an explanation of the provisions of S. 1804. Part four is an economic analysis of S. 1804. Appendix A provides a side-by-side comparison of the principal provisions of DISC and the proposed FSC; Appendix B contains relevant GATT documents; and Appendix C contains a flow chart illustrating how taxpayers would qualify for the benefits of S. 1804.

I. SUMMARY

Domestic International Sales Corporations (DISCs)

Originally proposed by the U.S. Treasury Department in 1970, a system of export income tax deferral for Domestic International Sales Corporations (DISCs) was enacted by Congress as Title V of the Revenue Act of 1971. The DISC legislation had several purposes. Congress was concerned that many trading nations provided more favorable tax treatment for their exports than the United States provided for U.S. exports, and intended to redress that imbalance in tax treatment. A second purpose was to stimulate exports and thereby improve the nation's balance of payments. A third purpose of DISC was to equalize the tax treatment accorded U.S.-based exporters, on the one hand, and U.S.-owned foreign manufacturing subsidiaries (not subject to current U.S. tax), on the other, and thereby remove an incentive to move manufacturing jobs overseas. It was anticipated that the DISC provisions would particularly aid smaller companies.

A DISC is typically a domestic subsidiary of a U.S. company that is engaged in exporting. The income attributable to qualified export receipts is apportioned between the parent and the DISC, using one of two optional formula pricing rules or, at the choice of the taxpayer, the arm's-length method.

The profits allocated to a DISC are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed or deemed distributed. Each year, a DISC is deemed to have distributed a portion of its income, thereby subjecting that income to current taxation in the shareholder's hands. As originally enacted, DISC generally provided for an annual deemed distribution of 50 percent of a DISC's profits. Thus, tax deferral was limited to 50 percent of the DISC's export income.

To qualify as a DISC, at least 95 percent of a corporation's assets must be export-related and at least 95 percent of the corporation's gross income must arise from export sales or lease transactions and other export-related activities. Special intercompany pricing rules apply with respect to transactions between a DISC and related parties. In general, under these pricing rules, a DISC may earn up to 4 percent of gross export receipts or 50 percent of the combined taxable income of the DISC and its supplier.

In the early and mid-1970s, there were legislative proposals to repeal the DISC legislation or to give the President authority to terminate the application of the DISC provisions as part of multilateral trade agreements. After examining the original DISC provisions at great length, Congress substantially amended them in the Tax Reform Act of 1976. The amendments reflected Congressional concern over the revenue cost of DISC and Congressional belief that the DISC program could be made more efficient and less costly while still providing the same incentive for increased exports and jobs. The most significant amendment was the addition of an incremental method for determining the annual deemed distribution. Generally, under this method, the portion of DISC income qualifying for tax deferral was reduced to 50 percent of the DISC income attributable to increased exports over a base-period figure. Small DISCs are exempted from the incremental rule.

In the Tax Equity and Fiscal Responsibility Act of 1982, Congress reduced the percentage applied to determine DISC income subject to deferral from 50 percent to 42.5 percent for corporate shareholders. This 42.5 percent deferral generally allows deferral of tax on as much as either (1) 21.25 percent of the combined taxable income of a DISC and its related supplier (under the 50-50 intercompany pricing rule), or (2) 1.7 percent of gross export receipts (under the four-percent intercompany pricing rule). Any application of the incremental rule reduces the amount of this deferral, however.

From its inception, DISC was the object of criticism from foreign countries. Several countries, along with the European Economic Community, alleged that DISC was an export subsidy that violated the General Agreement on Tariffs and Trade (GATT). Without agreeing that DISC violates GATT, the Administration has proposed the repeal of DISC and its replacement with a new entity, the "Foreign Sales Corporation" (contained in S. 1804, summarized below).

S. 1804—Foreign Sales Corporation Act

FSC Provisions

S. 1804, the proposed Foreign Sales Corporation Act, would provide a new set of tax rules for exports of goods and services. The bill would provide for the establishment of foreign sales corporations (FSCs) which would typically be foreign incorporated subsidiaries of U.S. parents engaged in exporting. Under the bill, an exporter using a FSC could use safe-harbor pricing rules that would generally exempt from U.S. income tax the greater of 17 percent of the taxable income that a FSC and a related party derive from an export transaction or up to some 1.35 percent of the gross receipts from the transaction. The bill would repeal the present DISC rules, with an exception for small exporters, and it would forgive tax on DISC income that has already benefited from tax deferral.

A FSC must be organized under the laws of a jurisdiction outside the U.S. customs area. It must have at least one director who is not a U.S. resident. It must maintain an office outside U.S. customs territory, and it must keep tax records both at that office and in the United States. Finally, it must elect FSC treatment.

The tax rules of the bill would apply to the export income of a FSC if it is managed outside the United States and if economic processes of the transaction take place outside the United States. In addition, the bill would apply to the export income of a small FSC attributable to up to $2,500,000 of export receipts whether or not its management or economic processes are foreign.

To be managed outside the United States, an FSC must have its shareholders' meetings, board meetings, and principal bank account outside the United States. To meet the foreign economic process test with respect to a transaction, the FSC or its agent must solicit, negotiate, or make the contract relating to the transaction outside the United States. In addition, half of the costs the FSC incurs for advertising, handling orders, transportation, collection, and assumption of credit risk with respect to a transaction must be for performance outside the United States; alternatively, 85 percent of its costs for any two of these five activities must be for their performance outside the United States.

Some export transactions between FSCs and related U.S. taxpayers would qualify for administrative transfer pricing rules. These administrative pricing rules would be available only if the foreign sales corporation or its agent performs all the activities of the economic process test. Under the administrative pricing rules, the FSC generally would earn the greater of 23 percent of the taxable income that it and its related party derive from the transaction or 1.83 percent of the gross receipts from the transaction.

The bill would exempt a portion of the export income of a foreign sales corporation from U.S. tax. If a transaction is subject to one of the administrative transfer pricing rules, this exempt portion would be 17/23 of FSC's income from the transaction. Less frequently, this exempt portion would be 34 percent of its export income. The rest of export income (including generally 6/23 of the FSC's income) would be subject to U.S. tax. All investment income of a FSC would also be subject to U.S. tax. Dividends from export income of a FSC to a U.S. corporate shareholder would be tax-exempt at the corporate shareholder level.

The bill would provide tax deferral under the present DISC rules for up to $10 million of export receipts for small exporters, but would require those companies to pay interest on the deferred tax.

The bill would require that FSCs and DISCs have the same taxable year as their parent corporations. It would provide that income from trade receivables of a related party would be passive income subject to the anti-incorporated pocketbook and anti-tax haven rules. Also, it would treat accumulated DISC income as having been previously taxed, so that tax on those amounts would be forgiven and all previously deferred income could be distributed tax-free.

Comparison of the Effects of DISC and FSC

Like the DISC legislation, the FSC proposal would lower the effective U.S. tax rate on income from capital used in the production of exports. However, it has been argued that the FSC substitute may be less efficient than DISC since exporters would incur operating expenses (and perhaps foreign taxes) associated with their offshore FSCs. Also, compared to DISC, the FSC substitute favors large, older, and slower growing exporters relative to small, new, and rapidly growing export companies. On the other hand, the FSC substitute does not contain some of the disadvantages of a DISC. For example, under the FSC rules there is no requirement equivalent to the qualified assets test; this results in two important differences between DISC and FSC. First, a company would have no restrictions under the FSC rules on how funds are invested; such flexibility is clearly important to business decisions. Second, the consequences of failure of a DISC to meet the qualified assets test (and the gross receipts test) are severe; all previously deferred income may be triggered. In contrast, no such harsh result with respect to prior years could occur under the FSC proposal. Furthermore, the captive DISC demand for Export-Import Bank obligations would be eliminated, reducing the bank's ability to finance U.S. exports.

II. BACKGROUND AND PRESENT LAW

A. DISC—Legislative History and Present Law

Overview

In the Revenue Act of 1971, Congress provided a system of tax deferral for corporations known as Domestic International Sales Corporations (DISCs) and their shareholders (Code secs. 991–997). The legislation creating DISC mandated annual Treasury Department reports on its operation and effect. The Treasury has issued 10 such reports, the most recent, covering 1981, in July 1983.[1] That report estimates that the DISC legislation increased exports in DISC year 1981 by between $7 billion and $11 billion over what they otherwise would have been. The estimated revenue cost of DISC in that year was $1.65 billion.

Background—U.S. Taxation of Foreign Income

The United States subjects to tax the worldwide income of any corporation organized under the laws of the United States. However, foreign corporations (even those that are subsidiaries of U.S. companies) generally are taxed by the United States only to the extent they earn income from a business in the United States or derive investment income there. As a result, the United States usually does not impose a tax on the foreign source income of a foreign corporation even though it is owned or controlled by U.S. persons. Instead, the foreign source earnings of a foreign corporation generally are subject to U.S. income taxes only when and if they are actually remitted to U.S. shareholders as dividends. The tax in this case is imposed on the U.S. shareholder and not the foreign corporation. U.S. tax on the dividend income may be offset by foreign tax credits.

An exception to the general rule is provided for certain "tax haven" base company type activities of controlled foreign corporations (sec. 951). These are foreign corporations more than 50 percent of the stock of which is owned by U.S. shareholders each of which owns at least 10 percent of the corporation's stock. The U.S. shareholders of these corporations are taxed under the subpart F provisions of the Code, enacted in 1962 (and subsequently amended). Under these provisions, certain earnings and profits of the controlled foreign corporation ("subpart F income") are deemed to be distributed to the U.S. shareholders, and are subject to taxation currently whether or not the shareholders actually receive the income in the form of a dividend.

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[1] Department of the Treasury, "The Operation and Effect of the Domestic International Sales Corporation Legislation, 1981 Annual Report," July 1983.

Subpart F income includes foreign base company sales income, which means sales income earned by a foreign subsidiary on the sale of property purchased from, or sold to, a related company if the property was neither manufactured in nor sold for use in the country in which the subsidiary is incorporated.[2] A U.S. manufacturer generally cannot establish a foreign sales subsidiary in a tax haven through which to route export transactions or other sales transactions without incurring U.S. tax on the subsidiary's income. Although the list of categories of subpart F income has grown and changed since 1962 and since enactment of DISC in 1971, the provision that subjects foreign base company sales income to current U.S. tax has remained basically the same.

Legislative History of DISC

1970 Administration proposal

The DISC legislation was first proposed by the U.S. Treasury Department in 1970.[3] The Treasury Department argued that changes were needed in the tax treatment of exported goods in order to encourage exports of U.S. goods and thereby improve the balance of payments.[4] Restriction of imports was considered impractical since it could invite retaliation by U.S. trading partners; also, the Treasury Department suggested that the freedom to import was one of the most effective possible checks on domestic inflationary pressures.

The Treasury Department argued that the existing tax structure tended to create an unnecessary drag on exports and gave some incentive to manufacture abroad rather than in the United States since income from the sale of the foreign manufacturing subsidiary's goods generally is not taxed by the United States until distributed to the shareholders. With the enactment of the anti-tax haven provisions of subpart F in the Revenue Act of 1962, full deferral generally could no longer be obtained by the use of a foreign sales subsidiary to distribute goods manufactured in the United States. In addition, other countries generally appeared to provide more favorable tax treatment for export income than the United States. The DISC legislation was intended to put the domestic manufacturer on a competitive basis with offshore manufacturing subsidiaries (and with foreign-owned manufacturers) by deferring a portion of income from tax until distributed to the shareholders.

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[2] There are now five other categories of subpart F income taxed currently to U.S. shareholders of controlled foreign corporations: (1) income from the insurance of U.S. risks; (2) passive investment income such as divideuds, interest, royalties, and rents ("foreign personal holding company income"); (3) income from services performed for or on behalf of a related person by the foreign subsidiary outside of the country in which it is incorporated ("foreign base company services income"); (4) shipping income earned by a foreign subsidiary outside of the country in which it is incorporated, if that income is not reinvested in shipping assets; and (5) foreign oil-related income (not including extraction income) such as income from processing, transporting, or distributing oil or gas if not earned in the country of extraction or consumption. In addition, investments by controlled foreign corporations in U.S. property (such as loans to the U.S. parent) are generally subject to U.S. tax to the extent of previously untaxed earnings (sec. 956).

[3] *See Domestic International Sales Corporation Proposal of the U.S. Treasury Department*, 91st Cong., 2d Sess. (Comm. Print 1970); Staff of House Comm. on Ways and Means, 91st Cong., 2d Sess., *Summary of Testimony Presented at Foreign Trade Hearings Conducted by Committee on Ways and Means*, 114-118 (Comm. Print 1970).

[4] At the time Treasury first proposed DISC, the value of the dollar in relation to other currencies was fixed by agreement among the major trading countries of the world. It appeared that the dollar was overvalued, a factor that tended to reduce exports. In August 1971, President Nixon moved to let the dollar float against other currencies.

The Treasury Department anticipated that the proposed DISC legislation would work more in favor of companies without existing large foreign structures and extensive foreign tax credits. Larger corporations, the Department suggested, were able to reduce their U.S. tax liability under then-existing law on export earnings by using foreign manufacturing subsidiaries, by making the minimum distribution election (now repealed) provided in subpart F (practically speaking, available only to U.S. exporters with substantial investments in foreign manufacturing facilities), and by means of the foreign tax credit. The DISC legislation was intended to provide equivalent opportunities for tax deferral on foreign income to smaller corporations and corporations newly entering the export market or expanding their export sales.

Proposed Trade Act of 1970

The Administration's 1970 DISC proposal was included in the proposed Trade Act of 1970.[5] The proposed Trade Act passed the House but was not enacted. The bill, H.R. 18970, would have phased in the DISC provisions over three years. Deferral of tax would have been permitted on 25 percent of a DISC's income in 1970, 50 percent in 1971, and 100 percent in 1972.

In its report on the bill, the House Committee on Ways and Means stated that the expansion of exports was an important national goal and that the nation's previous strong surplus in export trade had to be restored in order to find a long-range answer to the balance-of-payments problem.[6]

The committee analyzed the effect of the disparate tax treatment given U.S. companies which exported goods abroad and U.S. companies which manufactured goods abroad in foreign subsidiaries, as follows: The exporter was discriminated against because he paid full U.S. taxes on a current basis; the U.S. company which manufactured abroad through a foreign subsidiary, on the other hand, generally was required to pay only the *foreign* taxes on its income on a current basis. Foreign taxes were found by the committee to average about 10 percentage points less than the regular U.S. corporate income tax. The committee also found that the existing tax structure encouraged the reinvestment of foreign earnings of foreign subsidiaries in plants or selling organizations located abroad, since this enabled the parent corporation to postpone the payment of the U.S. tax which would result if the foreign earnings were remitted to the United States. The DISC provisions of the bill were designed to remove the U.S. exporter's disadvantage by freeing him from U.S tax as long as he continued to use export income to expand his export sales organization or to invest his export income in production facilities, to the extent the facilities were used to produce goods in the United States for sales abroad.

The committee expressed the belief that the DISC provisions would encourage domestic companies to engage in export activities and also encourage those who, in any event, would engage in sales abroad to locate their manufacturing plants in the United States rather than in foreign countries.

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[5] H.R. 18970, 91st Cong., 2d Sess. (1970).

[6] *See* H. Rep. No. 1435, 91st Cong., 2d Sess. 7-8, 15-20, 58-59 (1970).

Citing various tax advantages provided by other countries to export trade, the committee stated that the deferral of U.S. tax for export companies was desirable so long as the use of the income in the export trade sales and production activities was continued. The committee also stated that the need to make U.S. exporters more competitive with exporters of other countries justified a clearer and more liberal allocation rule in determining the transfer price from domestic producers to export sales subsidiaries.[7]

In the committee's view, the DISC provisions could be expected to give rise to increased export sales in a number of ways. Exports might be increased through using part of the deferred tax resulting from the provisions to lower export prices.[8] More importantly, exports might be increased through increased promotional efforts by U.S. business. By increasing the profitability of exporting, the committee suggested, it would be possible to induce exporters to take positive actions to build up their export markets. Exports might also be increased because the DISC provisions would encourage plant location in the United States, rather than abroad. The DISC provisions would do so not only because of the deferral provided but also because the DISC would be permitted to make loans to its parent ("producer's loans") without the current payment of tax and, thus, could aid substantially in the expansion of plant facilities in the United States to be used for production for exporting.

The committee noted that the DISC bill included provisions especially designed to enable small businesses to take advantage of DISC benefits. For example, small businesses could qualify for DISC treatment though they left most of their selling arrangements to brokers who made sales for them on a commission. The committee believed that this would enable small businesses to obtain the advantage of economy of scale in their selling costs by arranging sales through a broker handling the sales of many small DISCs.

Finally, the committee suggested that, while larger companies would share with small- or medium-sized companies in the incentive to export provided by the DISC provisions, the stimulant in their case was likely to be less than that for small companies. Many larger companies already obtained the advantage of postponement of U.S. tax under existing law in the case of their sales abroad through the use of foreign subsidiaries or other arrangements.

1971 Administration proposal

The Administration reintroduced its 1970 DISC proposal in 1971.[9] The only change made in the 1971 proposal was the recommendation that it be fully effective in 1972 rather than be phased in over several years.

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[7] H. Rep. No. 1435, 91st Cong., 2d. Sess. 15-16 (1970).

[8] *Id.* at 18.

[9] *See Hearings on H.R. 10947 Before the Senate Comm. on Finance*, 92d Cong., 1st Sess. 14-77 (1971) (testimony of John B. Connally).

In connection with the 1971 proposal, the Treasury Department argued that DISC would serve the interests of labor, business, and consumers. Labor would benefit by the increase in U.S. jobs. Business would benefit because many U.S. businessmen, it was argued, would prefer to continue producing in the United States for export markets if the tax treatment of U.S. and foreign production could be equalized. Consumers would benefit because a higher level of exports was needed to support continued expansion of imports.

The Treasury Department also stated that it was becoming increasingly difficult to support a policy that the United States should be a model for other countries by fully taxing its export income. (The subpart F provisions enacted in 1962 were generally intended to subject export income of foreign base companies to tax currently.) According to the Department, the effect of this policy had been the erosion of production in the United States and the transfer of jobs to foreign manufacturing in cases in which tax factors influence decisions on the source of production. The Department reported that the United States had no followers in its effort fully to tax export income currently.

The Treasury Department described the DISC proposal as an effort to cut through the existing complexity of U.S. tax rules applicable to foreign income, and to provide forthrightly the opportunity for tax deferral by use of a domestic corporation rather than a foreign subsidiary.

The Revenue Act of 1971

In 1971, the House passed, as part of the Revenue Act of 1971, a set of DISC provisions broadly similar to those incorporated in the proposed Trade Act of 1970.[10] Unlike the earlier proposed DISC provisions, the 1971 DISC provisions passed by the House in H.R. 10947 generally were to apply only on an incremental basis, to export income in excess of a specified base. Under the House bill, deferral of tax was permitted on export income attributable to sales in excess of 75 percent of the average export sales of the corporate group to which the DISC belonged for the years through 1970. Deferral was granted on 100 percent of this export income.

In its report on the bill,[11] the House Committee on Ways and Means stated that the incremental approach had the advantage of concentrating the benefits of DISC treatment on firms which increased their exports and, thus, would make a greater contribution to resolving the U.S. balance of payments problem.

The Treasury Department opposed the incremental approach.[12] Noting that DISC was designed to induce companies to continue manufacturing in the United States for sale abroad, thus keeping jobs at home, the Treasury Department argued that this purpose would be largely frustrated by the incremental approach because many leading U.S. exporters had had declining or level exports in recent years. These companies would have no incentive to continue manufacturing in the United States for foreign markets under an incremental rule. In the case of other companies, the Treasury Department suggested, the incremental approach at best would provide only partial deferral treatment, so the effectiveness of DISC in keeping jobs at home would be greatly reduced.

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[10] *Compare* H.R. 10947, 92d Cong., 1st Sess. (1971) *with* H.R. 18970, 91st Cong., 2d Sess. (1970).

[11] *See* H. Rep. No. 533, 92d Cong., 1st Sess. 39, 58-59 (1971).

[12] *See Hearings on H.R. 10947 Before the Senate Comm. on Finance*, 92d Cong., 1st Sess. 14-16 (1971).

Further, the Treasury Department argued, the incremental approach overlooked the fact that, from a balance of payments standpoint, it was as important to maintain a dollar of existing export sales as to increase export sales by a dollar. The incremental approach would not provide any incentive to help arrest the decline in export sales. The incremental approach also, it was suggested, would penalize corporations who made substantial efforts to maintain or boost their exports in base period years. Finally, the incremental approach was criticized as too complex.

The Senate Finance Committee version of the bill containing the DISC provisions eliminated the incremental approach.[13] A provision was included instead that limited deferral of tax to 50 percent of the export profit of a DISC. The Senate Finance Committee made this change because the committee believed it would make the DISC provisions simpler and more equitable.

The Senate Finance Committee version of the bill also included a provision that would have terminated the DISC system after 10 years—in 1982.[14] This was intended to give Congress a subsequent opportunity to review the need for the DISC provisions in light of the changing international monetary situation.

In addition, the Senate Finance Committee amended the House bill to provide that, to the extent the controlled group, which included the DISC, invested profits of the DISC in foreign plant and equipment, deferral was to cease with respect to those profits. The committee was concerned that the tax-deferred profits of a DISC which were lent to the DISC's parent company (or affiliated company) might be used for investments in foreign plants and equipment by the parent (or domestic or foreign affiliate).

The DISC provisions enacted in the Revenue Act of 1971 followed closely the Senate amendments. An important change was the deletion of the built-in termination date.

In their reports on the legislation, both the House Committee on Ways and Means and the Senate Committee on Finance indicated that it was important to provide tax incentives for U.S. firms to increase exports not only because of the stimulative effects of such incentives but also to remove the existing tax disadvantage of U.S. companies engaged in export activities through domestic corporations.[15] The Treasury Department had described this tax disadvantage in connection with its 1970 and 1971 DISC proposals and the House Ways and Means Committee had reiterated it in its report on the proposed Trade Act of 1970.

The House and Senate Committees emphasized that other major trading nations encouraged exports. The Senate report added that both the House and Senate versions of the DISC provisions were designed to remove tax disadvantages for U.S. manufacturing, but to avoid granting undue tax advantages to DISCs.[16]

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[13] *See* S. Rep. No. 437, 92d Cong. 1st Sess. 12-13, 90-129 (1971).

[14] This period was reduced to seven years by a Senate floor amendment.

[15] H. Rep. No. 533, 92d Cong., 1st Sess. 58 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971).

Public Law 93-482 and the Tax Reduction Act of 1975

Public Law 93-482 amended the DISC provisions to enable a financing corporation to qualify as a DISC. This change was made because it came to Congress' attention that a corporation might want to have its sales operations in one DISC and its financing operations in another DISC. A corporation might adopt this corporate structure because it believed the structure would improve its ability to receive outside financing.[17]

The Tax Reduction Act of 1975 amended the DISC provisions to deny DISC benefits for the export of natural resources and energy products (i.e., products for which an allowance for cost depletion is provided) and for products subject to export control under the Export Administration Act of 1969. The Tax Reform Act of 1976 excluded from this amendment sales, exchanges, and other dispositions made after March 18, 1975, and before March 19, 1980, if made pursuant to a fixed contract.

The Tax Reform Act of 1976

Prior to the Tax Reform Act of 1976, legislative proposals were made to eliminate the DISC system entirely, or to give the President authority to terminate the application of the DISC provisions as part of a trade agreement between the United States and a foreign country.[18]

In considering the 1976 legislation, Congress examined the original DISC provisions at great length. It concluded that the DISC provisions had increased U.S. exports. While much of the increase in U.S. exports from 1971, when the DISC provisions were enacted, through 1975, had resulted from the devaluation of the U.S. dollar during that period, Congress believed that a significant portion of the increase resulted from the DISC legislation. This increase in exports, Congress concluded, provided jobs for U.S. workers and helped the U.S. balance of payments.

However, Congress also recognized that questions had been raised as to the revenue cost of DISC. In 1975, the system was estimated to have cost nearly $1.3 billion, and it was estimated that in 1976 the amount would have been $1.4 billion. Further, Congress believed that DISC was made less efficient because DISC benefits applied to all exports of a company, regardless of whether a company's products would be sold in similar amounts without export incentive and regardless of whether the company was increasing or decreasing its exports.

Congress concluded that the DISC program could be made more efficient and less costly while still providing the same incentive for increased exports and jobs. [19] The Tax Reform Act of 1976 made substantial changes in the DISC provisions. Perhaps most significantly, the legislation adopted an incremental approach to DISC benefits under which deferral generally was granted only to the extent of 50 percent of a company's income attributable to increases in its exports over a base period amount. Under prior law, tax generally was deferred on 50 percent of a DISC's income, regardless of whether its exports had increased.[20] The Act also reduced DISC benefits for military goods.

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[16] S. Rep. No. 437, 92d Cong., 1st Sess. 13 (1971).

[17] S. Rep. No. 1060, 93d Cong., 2d Sess. 4-5 (1974). *See also* H. Rep. No. 1402, 93d Cong., 2d Sess. (1974).

[18] *See, e.g.*, S. 1439, 93d Cong., 1st Sess. (1973); H.R. 15452, 93d Cong., 2d Sess. (1974); H.R. 17488, 93d Cong., 2d Sess. (1974).

[19] *See* H. Rep. No. 658, 94th Cong., 1st Sess., 263-64 (1975); S. Rep. No. 938, 94th Cong., 2d Sess., 291-92 (1976).

Tax Equity and Fiscal Responsibility Act of 1982

For corporate shareholders, the Tax Equity and Fiscal Responsibility Act of 1982 reduced the deferral rate on incremental DISC income from 50 to 42.5 percent. This change had the effect of reducing DISC tax benefits by 15 percent.

In 1982, Congress reduced corporate tax preferences, including DISC benefits, because (1) the Federal budget faced large deficits, (2) the Accelerated Cost Recovery System enacted in 1981 made some corporate tax preferences less necessary, and (3) there was increasing concern about the equity of the tax system, and cutting back corporate tax preferences was considered a valid response to that concern.[21]

Summary of Present DISC Rules

The profits of a DISC are not taxed to the DISC but are taxed to the shareholders of the DISC when distributed or deemed distributed to them. Each year, a DISC is deemed to have distributed a portion (discussed below) of its income, thereby subjecting that income to current taxation in the shareholders' hands.[22] Federal income tax can generally be deferred on the remaining portion of the DISC's taxable income until the income is actually distributed to the DISC shareholders, a shareholder disposes of the DISC stock, the DISC is liquidated, distributed, exchanged, or sold, the corporation ceases to qualify as a DISC, or the DISC election is terminated or revoked.

Under the pre-1976 rules, a DISC was deemed to have distributed income representing 50 percent of its export profits and 100 percent of its non-export profits. In this way, under the prior rules, the tax deferral which was available under the DISC provisions was limited to 50 percent of the export income of the DISC. Under current rules, DISC benefits (deferral of tax on 42.5 percent of profits) are limited to income attributable to export gross receipts in excess of 67 percent of average export gross receipts in a 4-year base period. These provisions are known as the incremental provisions. The base period years are the fourth, fifth, sixth, and seventh preceding years. For example, the base period is 1973 through 1976 for taxable years beginning in 1981. If the taxpayer does not have a DISC in any year which would be included in the base period for the current year, the taxpayer is to calculate base period export gross receipts by attributing a zero amount of export gross receipts to that base period year. DISCs with adjusted taxable income of $100,000 or less are exempt from the incremental rule. This exemption is phased out as adjusted taxable income increases from $100,000 to $150,000.

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[20] "Small" DISCs were excluded from the incremental rules.

[21] Staff of Joint Comm. on Taxation, 97th Cong., *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982*, 30-32 (Joint Comm. Print 1982).

[22] In the typical case, a DISC is a wholly-owned subsidiary of a U.S. corporation, so distributions and deemed distributions from DISCs are typically subject to corporate tax and, eventually, to shareholder level tax when distributed to individuals.

The incremental provisions include special rules to deal with situations where a corporation has an interest in more than one DISC, or where a DISC and the underlying trade or business giving rise to the DISC income have been separated. The purposes of these rules are, first, to insure that in every year the base period export gross receipts which are attributable to a DISC for purposes of deemed distributions in the current year are appropriately matched with the current period export receipts of the DISC and, second, to prevent taxpayers from creating multiple DISCs, or swapping DISCs, to avoid the effect of the incremental rule.

To qualify for tax exemption, a DISC must be incorporated under the laws of any of the States or the District of Columbia, have only one class of stock, have outstanding capital stock with a par or stated value of at least $2,500, elect to be treated as a DISC, and satisfy the gross receipts and gross assets tests.

The gross receipts test requires that at least 95 percent of the corporation's gross receipts consist of qualified export receipts. In general, qualified export receipts are receipts, including commission receipts, derived from the sale or lease for use outside the United States of export property, or from the furnishing of services related or subsidiary to the sale or lease of export property. Interest on any obligation which is a qualified export asset is also an export receipt. Export property must be manufactured, produced, grown, or extracted in the United States. Exports subsidized by the U.S. Government or exports intended for ultimate use in the United States do not qualify as export property. The President has the authority to exclude from export property any property which he determines (by Executive order) to be in short supply. However, energy resources, such as oil and gas and depletable minerals, are automatically denied DISC benefits under the Tax Reduction Act of 1975. That Act also eliminated DISC benefits for products the export of which is prohibited or curtailed under the Export Administration Act of 1969 by reason of scarcity. The Tax Reform Act of 1976 reduced DISC deferral on sales of military goods to half the amount which would otherwise be allowed.

The gross assets test requires that at least 95 percent of the corporation's assets qualify as export assets. Qualified export assets include inventories of export property, necessary operational equipment and supplies, trade receivables from export sales (including certain commissions receivable), producer's loans, working capital, obligations of domestic corporations organized solely to finance export sales under guaranty agreements with the Export-Import Bank, and obligations issued, guaranteed, or insured by the Export-Import Bank or the Foreign Credit Insurance Association. In certain situations, nonqualified assets and receipts may be distributed in order to satisfy these qualification requirements.

If a DISC fails to meet the qualifications for any reason, the DISC provisions provide for an automatic recapture of the DISC benefits received in previous years. Recapture of accumulated DISC earnings (because the DISC has become disqualified) is to be spread out over a period equal to two years for each year that the DISC was in existence (up to a maximum of 10 years).

The DISC provisions include special elective intercompany pricing rules, which may be used in lieu of the general intercompany pricing rules of the Code, in order to determine the profits which a DISC may earn on products which it purchases from a related company and then resells for export or which it sells on a commission basis. In general, a DISC may earn up to 4 percent of gross export receipts from a transaction or 50 percent of combined taxable income of the DISC and its related party; in either case, the DISC also earns 10 percent of export promotion expenses. Export promotion expenses include freight expenses to the extent of 50 percent of the cost of shipping export property aboard airplanes owned and operated by U.S. persons or ships documented under the laws of the United States in those cases where law does not require use of such airplanes or ships. (Alternatively, the DISC and its related party may choose a price determined under the usual arm's-length rules.) Neither the 4-percent method nor the 50-50 method can be applied to cause a loss to the related supplier while the DISC is earning a net profit.

Under marginal costing rules, if the 50-50 method is used by the DISC, only the marginal or variable production and sales costs for the export property need be included in the computation of combined taxable income. In general, the benefits of marginal cost pricing are limited to instances where the variable cost margin on the DISC's export sales of a product is less than the full cost margin on the combined product sales by the DISC and the related supplier.

A DISC's taxable year need not conform to the taxable year of any of its shareholders. A wholly owned DISC will frequently have a taxable year ending one month after its parent's taxable year ends. This difference in taxable years allows an additional 11 months of deferral of income that is deemed distributed to the parent.

Source of Income from Export Sales

The United States taxes U.S. taxpayers on their U.S. and foreign source income, but allows a foreign tax credit for foreign taxes on foreign source income. The foreign tax credit limitation reflects the principle that the credit cannot exceed U.S. tax on foreign source income. In general, in calculating the limitation, most foreign source income is lumped together in a general category known as the "all other" category; a separate limitation or "basket" applies to certain income from deemed DISC distributions (and, separately, to certain interest), however. In most cases, an export sale will not attract foreign tax so long as the U.S. seller does not perform substantial activities in the country of destination. The reason for the separate limitation is that Congress, in enacting the original DISC legislation, did not intend to enable taxpayers to reduce U.S. taxes on low-foreign-taxed distributions from DISCs by crediting foreign taxes on non-DISC income against the U.S. tax on distributions from DISCs.

Income of a U.S. person that exports property produced in the United States directly (without using a DISC) is treated as income partly from within and partly from without the United States (sec. 863(b)). This income is not subject to the separate foreign tax credit limitation applicable to DISC income. To the extent that the income is from sources without the United States, it increases the taxpayer's foreign tax credit limitation in the general "all other" category, and thus the foreign taxes that the taxpayer may credit.

An approximation of the portion of income from a typical direct export sale that is foreign source income is 50 percent (see Treas. Reg. sec. 1.863-3(a)(2) (Example (2)). Therefore, a taxpayer with substantial excess foreign tax credits who can make an export sale directly (rather than through a DISC) without incurring foreign tax on the transaction may be subject to tax on only half the income from the export sale.

For example, a U.S. exporter who can make an export sale at a profit of $100 may be able to treat $50 of that income as foreign source. The taxpayer may be able to arrange the sale so that the $50 of foreign source income attracts no foreign tax. Given sufficient excess foreign tax credits, the sale will attract no U.S. tax, either. In that case, the taxpayer will be taxable on only the $50 of income that is U.S. source income.

By contrast, that exporter with excess foreign tax credits may be taxable on $58 of income if it routes the export sale through a DISC. The following table assumes a 17 percent deferral rate for combined taxable income (CTI) of DISC and parent. (This assumed 17-percent deferral rate forms the basis of the FSC proposal.)

Current Law—DISC—50/50 Split of CTI—Sec. 863(b)

(Exporter With Excess Foreign Tax Credits)

Parent		*DISC*	
U.S. source (taxable)	$25	Deferred	$17
Foreign source (exempt)	25	Deemed distribution	33
	50		50

Taxable:	
U.S. source income of parent	$25
Deemed distribution—separate basket	33
	58
Exempt:	
Foreign source income of parent	$25
Deferred in DISC	17
	42

Therefore, some exporters with excess foreign tax credits will choose not to route their export transactions through DISCs.

Income From Factoring Trade Receivables

When a seller of goods or services extends credit to a purchaser, the seller generally takes from the purchaser a transferable promise to pay in the future (an "account receivable" or a "trade receivable"). If the seller sells that receivable (the promise to pay the debt obligation) to a "factor," the factor earns "factoring" income when it collects the debt for its own account. The factor pays the seller less than the face value of the obligation, that is, the factor buys at a discount. The seller will sell at a discount for two reasons: first, to realize cash from the sale sooner than the buyer would pay for the goods or services, and second, to shift some of the risk of collecting the receivable. The seller would claim a loss from the disposition of the debt obligation for less than face value. The factor may assume some risk that the purchaser of goods or services will not pay its debt. In the typical case, the factor will earn some income because of the time value of money. That is, the reduced price that the factor pays the seller for the obligation will reflect an element of interest income.

Some taxpayers take the position that a controlled foreign corporation located in a tax haven can factor receivables arising from sales of goods or services by related parties without any U.S. tax. For this arrangement to avoid U.S. tax, certain issues would have to be resolved, including (1) whether the discount income is interest, (2) whether the purchase and collection of receivables is a trade or business within the United States, (3) whether the purchase of receivables is an investment in U.S. property, and (4) whether the discount is subpart F income.

There is authority that discount income earned by an active factoring business is not interest for purposes of the personal holding company rules (*Elk Discount Corp.*, 4 T.C. 196 (1944)), or for purposes of the Subchapter S rules (*Thompson* v. *Commissioner*, 73 T.C. 878 (1980)). The Service has held in one instance that discount income that a foreign subsidiary of a U.S. corporation earned was not interest income and was not subject to the anti-tax haven rules of Subpart F of the Internal Revenue Code as foreign personal holding income (private letter ruling 8338043, June 17, 1983).

If a foreign corporation buys receivables of U.S. obligors and then collects the amounts due, that foreign corporation may be engaged in U.S. business. If it is engaged in U.S. business, then its factoring income will be subject to U.S. tax. It is unclear under present law whether foreign corporations that buy obligations of U.S. persons and collect them are engaged in U.S. business (see private letter ruling 8338043, referred to above, which did not rule on the issue). Determination of this issue may depend on individual factual circumstances.

In addition, a U.S. shareholder of a controlled foreign corporation is taxable on its pro rata share of the increase in the taxable year of the foreign corporation's earnings invested in U.S. property (section 956). U.S. property generally includes any obligation of a U.S. person. However, a special rule excludes obligations of unrelated U.S. corporations (sec. 956(b)(2)(F)).

Factoring income of a controlled foreign corporation may be subject to other anti-tax haven rules of Subpart F. For example, factoring income may be foreign base company services income, which is income from services performed by or on behalf of a related person outside the country of incorporation of the controlled foreign corporation (sec. 954(e) (see private letter ruling 8338043, noted above, which did not rule on the issue)).

These rules applicable to controlled foreign corporations do not apply to DISCs. Three benefits arise when a DISC holds the receivables arising from export sales: (1) its parent gets cash, (2) the receivables help the DISC meet the qualified export assets test, and (3) the discount income is eligible for deferral. The discount, if treated as interest, would be treated as the DISC's income alone; it would not be included in combined taxable income for purposes of the 50-50 profit split. To the extent the discount income is not shared with the parent as combined taxable income, the DISC gets additional deferral (i.e., the DISC gets deferral on 42.5 percent of the full amount of the discount rather than 42.5 percent of half the discount).

B. The General Agreement on Tariffs and Trade (GATT)

Concern about U.S. obligations under the General Agreement on Tariffs and Trade (the "General Agreement" or GATT)[23] has motivated introduction of legislation dealing with the Domestic International Sales Corporation provisions.[24] The General Agreement became open for acceptance in October 1947; its provisions (as amended) apply to the United States, the developed countries of the free world, most of the world's developing countries, and a few communist countries.

Substantive Provisions in General

The thrust of the General Agreement is to prevent countries from favoring domestic goods over foreign goods. The typical method of favoring domestic goods is by import duties. The General Agreement also contains provisions designed to limit subsidies for domestic goods. First, countries must report to the GATT membership subsidies that reduce imports or increase exports (Article XVI:1 of the General Agreement). Article XVI is reproduced in Appendix B.

Second, the General Agreement proscribes export subsidies. It imposes different standards on export subsidies for primary products (such as minerals and agricultural commodities) and non-primary products. Any subsidy which increases the export of a primary product is not to result in a country having more than an equitable share of world export trade in that product (Article XVI(3)).

Countries are to cease granting subsidies on non-primary products when the subsidy results in export sales at lower prices than domestic sales (Article XVI:4). This standard for non-primary products is a "bi-level pricing" standard.

Remedies in General

If actions of one country nullify or impair any benefit that accrues to another country under the General Agreement, the injured country is to notify the offending country. If the two countries cannot solve the problem, the general membership of GATT is to investigate the matter, and make recommendations, or give a ruling. The general membership may authorize the injured country to suspend the concessions, such as reduced tariffs, it made to the offending country under the General Agreement.[25]

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[23] This pamphlet uses the term GATT to mean the agreement or the countries that subscribe to it, as the context requires.

[24] Statements of Senator Dole, 129 *Cong. Rec.* S11761 (August 4, 1983) and *id.* S12072 (September 13, 1983); Statement of Senator Danforth, *id.* S11766 (August 4, 1983).

[25] The text of the GATT provision governing these remedies, Article XXIII, is included in Appendix B.

The Illustrative List

In 1960, a GATT working party adopted an "illustrative list" of "practices generally . . . considered as subsidies" under Article XVI:4 (BISD (Basic Instruments and Selected Documents), 9 Suppl. p. 186). These included:

"(c) The remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises;" and"

"(d) The exemption, in respect of exported goods, of charges or taxes, other than charges in connection with importation or indirect taxes levied at one or several stages on the same goods if sold for internal consumption. . . ."

For GATT purposes, there is a distinction between "direct" and "indirect" taxes. Income taxes, such as the U.S. corporate income tax, are "direct" taxes, while some other taxes, such as Value Added Taxes (V.A.T.), are "indirect" taxes. Therefore, forgiveness of corporate income tax on export profits may violate GATT rules, while remission of a V.A.T. may not violate those rules.

The members of the European Economic Community (and other countries) generally impose high Value Added Taxes on goods consumed locally, but they rebate those taxes for exported goods. The staff is not aware of any challenge to this practice of EEC member countries.[26]

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[26] For criticism of the effect of this distinction between direct and indirect taxes, see the remarks of Senator Long in *Hearings before the Committee on Finance, U.S. Senate, Nomination of John B. Connally, of Texas, to be Secretary of the Treasury,* January 28 and February 2, 1971, at 39-40. See also U.S. Department of the Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation, 1976 Annual Report* at 30-32, and Jackson, "The Jurisprudence of International Trade: The DISC Case in GATT," 72 *Am. Journal of Int'l Law* 747, 751 & n.15.

C. GATT's reaction to DISC

The Treasury Department first proposed DISC to Congress in 1970. Before DISC's enactment, the European Economic Community (EEC) indicated its view that DISC constituted a "tax privilege" and a "tax incentive to exports" and "would be contrary to the United States' commitments under the General Agreement."[27] Canada, Switzerland, and Sweden also expressed concern about the DISC proposal.

The DISC provisions became effective on January 1, 1972; early in that year, the EEC formally requested consultation with the United States about DISC. The United States then sought consultations with France, Belgium and the Netherlands with respect to those countries' tax systems, which exempted profits of foreign sales corporations. The United States argued that those countries' territorial tax systems were as generous as or more generous than DISC for exports and that either all were legal under GATT or all were illegal.

In general, these three countries use a "territorial" system of taxation in which profits generated by undertakings operated abroad are exempt from home-country tax.[28] In general, these three countries have low taxes (or no taxes) on foreign profits brought back into the country. Each of these countries, in principle, generally requires arm's-length pricing between related parties, but it is not clear how well these countries enforce or enforced the arm's-length standard.

By 1973, both the United States and the EEC had formally complained to the GATT membership about the alleged tax export subsidies. The GATT Council directed that a Panel of experts examine DISC and the tax practices of France, Belgium and the Netherlands.

In late 1976, the GATT Panel issued reports on the tax practices of all four countries.[29] The Panel concluded that the DISC legislation conferred a tax benefit essentially related to exports, and that this would tend to lead to an expansion of export activity. The Panel noted that the DISC legislation was intended to increase United States exports and noted that the Treasury Department had reported that DISC had in fact increased exports. The Panel further noted that the deferral of tax under the DISC legislation did not attract the interest component of the tax normally levied for late or deferred payment and therefore concluded that, to this extent, the DISC legislation constituted a partial exemption which was either "a remission" or "an exemption" (or both) that was improper under the illustrative list of 1960. The Panel indicated that remissions and exemptions were generally to be considered as subsidies in the sense of Article XVI:4.

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[27] Note on Exchange of Views, GATT Doc. L/3574 (September 13, 1971). For discussions of GATT's reaction to DISC; see Cohen and Hankin, "A Decade of DISC: Genesis and Analysis," 2 *Va. Tax Rev.* 7 (1982), Jackson, "The Jurisprudence of International Trade: The DISC Case in GATT," 72 *American Journal of International Law* 747 (1978); Kwako, "Tax Incentives for Exports, Permissible and Proscribed: An Analysis of the Corporate Income Tax Implications of the MTA Subsidies Code," 12 *Law & Policy in Int'l Bus.* 676 (1980).

[28] This exemption applies not only to exports, but also to purely foreign transactions. For example, profits of a non-French branch (or subsidiary) of a French corporation would generally be exempt from French tax, and would be subject to a low rate of tax (that could be zero in certain cases) on repatriation.

[29] Appendix B of this pamphlet reproduces in full the Panel's conclusions with respect to DISC.

The Panel indicated that the DISC legislation could be presumed to result in bi-level pricing. The Panel considered that an export subsidy would lead to any or a combination of the following consequences in the export sector: (a) lowering of prices, (b) increase of sales effort and (c) increase of profits per unit. The Panel expected that all of these effects would occur and that a concentration of the subsidy benefits on prices could lead to substantial reductions in prices. The Panel therefore concluded that the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4 with respect to non-primary products. The Panel did not examine whether the DISC legislation would give the United States a disproportionate share of the world market in primary products (in terms of Article XVI:3).

The Panel did not accept the United States argument that it had introduced the DISC legislation to correct an existing distortion created by tax practices of certain other contracting parties. The Panel said that that one distortion could not be justified by the existence of another one. In conclusion, the Panel found that there was a *prima facie* case of nullification or impairment of benefits which other countries were entitled to expect under the General Agreement.

On the day that the Panel issued its report on DISC, the three Panels examining the tax practices of France, Belgium, and the Netherlands issued their reports. (The membership of these three Panels was identical to that of the DISC Panel.)

The GATT Panel reports on the tax systems of France, Belgium, and the Netherlands are similar in their analysis and conclusions to the report on DISC.[30] The GATT Panel reports on these three tax systems noted that their application of the territoriality principle allowed some part of export activities to be outside the scope of home country taxes. In this way each country created a possibility of a pecuniary benefit to exports. The Panel did not find it significant (1) that territoriality was a long-standing practice in each country, not created to benefit exports or (2) that each country's territorial system exempted income from foreign investment generally, and not just income from export activity.

The Panel also noted that taxation of dividends from abroad at a nominal rate preserved these tax benefits for exports. The Panel concluded in each case that there was a partial exemption from direct taxes which was either "a remission" or "an exemption" (or both) that was improper under the illustrative list of 1960. The

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[30] These reports are "Income Tax Practices Maintained by France," GATT Doc. No. L/4423 (Nov. 2, 1976); "Income Tax Practices Maintained by Belgium," GATT Doc. No. L/4424 (Nov. 2, 1976); GATT, "Income Tax Practices Maintained by the Netherlands," GATT Doc. No. L/4425 (Nov. 2, 1976). Appendix B of this pamphlet contains excerpts from the Panel Report on France.

Panel indicated that remissions and exemptions were generally to be considered as subsidies in the sense of Article XVI:4. The Panel added (with respect to each case) that bi-level pricing had probably occurred and concluded that each country's tax practices in some cases had effects which were not in accordance with its obligations under Article XVI:4 with respect to non-primary products. The Panel noted that each country might allow deviations from the arm's-length pricing principle in calculating the allocation of profits between companies and their foreign operations. The Panel found in each case that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement.

Belgium and France contested the findings with respect to their tax practices with the argument that exportation (that a tax system could subsidize in violation of GATT) ends at the customs frontier of the importing country. The argument of Belgium was as follows:

"It is clear that export activities end the moment that the foreign importer takes possession of the exported products. All further activities take place at the level of the importer, whether the importer is a fully independent company, or a branch or subsidiary company. Such activities do not enter into the framework of export operations and therefore fall outside the scope of Article XVI:4."[31]

There was no GATT action on these Panel reports until December 1981. The delay was due in part to negotiations that led up to adoption, in 1979, of an "Agreement on Interpretation and Application of Articles VI, XVI, and XXIII" of the General Agreement.[32] This agreement is generally known as the "Subsidies Code." An Annex to that Agreement contained an updated "Illustrative list of export subsidies," which included the following item:

"(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises."

The inclusion of "deferral" in this item represented a significant departure from the 1960 list. One footnote[33] to that item explained that deferral need not amount to an export subsidy where appropriate interest charges are collected. That footnote also indicated (1) that the reference to deferral was not intended to prejudge the DISC case; (2) that the arm's-length pricing standard should apply in transactions between exporting enterprises and foreign buyers under common control; and (3) that this item was not intended to limit measures to avoid the double taxation of foreign source income.

At a meeting in December 1981, the GATT Council adopted all four panel reports but with three qualifications.[34] First, GATT does not require an exporting country to tax economic events that take place outside its territorial limits. Second, GATT (Article XVI:4) requires arm's-length pricing in transactions between exporting enterprises and foreign buyers under common control.

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[31] GATT Doc. C/98, March 14, 1977.

[32] See Agreements Reached in the Tokyo Round of the Multilateral Trade Negotiations, H.R. Doc. No. 153, 96th Cong., 1st Sess., pt. 1 (1979).

[33] The text of that footnote appears in Appendix B.

[34] The text of the agreement is found in Appendix B.

Third, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

This agreement reflects some of the concepts of the 1979 Subsidies Code. The effect of this agreement on DISC is not clear. In December 1981, David R. MacDonald, Deputy U.S. Trade Representative, stated his office's position that DISC did not violate the principles of GATT, and that this agreement left the United States "under no obligation to modify or eliminate the DISC."[35] In October 1982 the Deputy U.S. Trade Representative informed the GATT Council that the Administration intended to propose legislation to address the concerns that GATT members had with DISC. In March 1983 the President's Cabinet Council on Commerce and Trade approved a proposal for a tax replacement for DISC. That proposal formed the basis for S. 1804 and an identical House bill, H.R. 3810.

The Treasury Department's annual report on DISC for 1981, issued in July 1983, expresses the Administration's official position on the GATT controversy:

"For several years, the provisions of the DISC legislation have been the subject of a dispute between the United States and other General Agreement on Tariffs and Trade (GATT) signatories. Those signatories contend that DISC amounts to an illegal export incentive which violates the GATT. The DISC was found to be an illegal export subsidy by a GATT panel in 1976 along with similar tax practices of Belgium, France, and the Netherlands. While the United States has never conceded that DISC violates the GATT, the United States agreed to the adoption of the GATT panel reports subject to the understanding that GATT signatories need not tax export income generated by economic processes outside their territorial limits, as long as arm's-length pricing principles are observed in transactions between related parties. The understanding also states that the GATT does not prohibit the adoption of measures to avoid the double taxation of foreign source income.

"The DISC dispute remains a serious irritant in U.S. trade relations with other countries, particularly the European Community. Thus, the United States informed the GATT Council in October, 1982 that it would propose to Congress legislation that would address the concerns of its trading partners. In March, 1983, the Administration announced the general elements of a tax alternative to DISC. Legislation on the proposed alternative was being drafted as this report was prepared."[36]

That legislation is S. 1804 (and the companion House bill, H.R. 3810).

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[35] 15 *Tax Notes* 884 (June 14, 1982).

[36] Department of the Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation, 1981 Annual Report,* 6 7 (July 1983).

III. EXPLANATION OF S. 1804 (FOREIGN SALES CORPORATION ACT OF 1983)

Overview

The bill would provide that a portion of the export income of an eligible foreign sales corporation (FSC) would be exempt from Federal income tax. It would also allow a domestic corporation a 100 percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income. Thus, there would be no corporate level tax imposed on a portion of the income from exports.

Under the GATT rules, an exemption from tax of export income is permitted only if the economic processes which give rise to the income take place outside the United States. In light of these rules, the bill would provide that a FSC must have a foreign presence, it must have economic substance, and that activities that give rise to the export income must be performed by the foreign sales corporation outside the U.S. customs territory. Furthermore, the income of the foreign sales corporation must be determined according to transfer prices specified in the bill: either actual prices for sales between unrelated, independent parties or, if the sales are between related parties, formula prices which are intended to comply with GATT's requirement of such arm's-length prices.

The bill would provide that the accumulated tax-deferred income of existing DISCs would be deemed previously taxed income and, therefore, would be exempt from taxation.

Small exporters may find it difficult to comply with certain of the foreign presence and economic activity requirements. The bill would provide, therefore, two options to alleviate the burden of the foreign presence and economic activity requirements to eligible small businesses: the interest-charge DISC and the small FSC.

Foreign sales corporation

To qualify as a FSC, a foreign corporation must have a foreign presence. In order to determine whether a corporation has a foreign presence, the bill would provide an objective test—the corporation must satisfy each of the following six requirements: The corporation must (1) be created or organized under the laws of any foreign country or possession of the United States (a term that includes Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Virgin Islands of the United States, but does not include Puerto Rico, because the United States includes Puerto Rico for purposes of the bill),[37] (2) have no more than 25 shareholders at any time during the taxable year, (3) not have any preferred stock outstanding at any time during the taxable year, (4) maintain an office located outside the United States, maintain a set of the permanent books of account at such office, and maintain within the United States the records required of a domestic corporation for tax purposes, (5) at all times during the taxable year have a board of directors which includes at least one individual who is not a resident of the United States, and (6) not be a member at any time during the taxable year of any controlled group of corporations of which a DISC is a member.

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[37] In other words, the corporation must be formed under the laws of a jurisdiction outside U.S. customs territory.

In addition to the above requirements, a FSC must make an election to be treated as a FSC.

Exempt foreign trade income

A portion of the foreign trade income of a FSC would be exempt from Federal income tax. To achieve this result, the exempt foreign trade income would be treated as foreign source income which is not effectively connected with the conduct of a trade or business within the United States. The portion of foreign trade income that is treated as exempt foreign trade income depends on the pricing rule used to determine the amount of foreign trade income earned by the FSC. If the amount of income earned by the FSC is based on arm's-length pricing between unrelated parties, or between related parties under the rules of section 482, then exempt foreign trade income is 34 percent of the foreign trade income derived from a transaction. If, however, the income earned by the foreign sales corporation is determined under the special administrative pricing rules, then the exempt foreign trade income is 17/23 of the foreign trade income derived from the transaction.

Exempt foreign trade income is an exclusion from gross income of the FSC. Any deductions of the FSC properly apportioned and allocated to the foreign trade income derived by the FSC from a transaction would be allocated on a proportionate basis between exempt and nonexempt foreign trade income. Thus, deductions allocable to exempt foreign trade income could not be used to reduce the taxable income of the FSC.

In general, no tax credits other than withholding or foreign tax credits would be allowed to a FSC.

Foreign trade income

Foreign trade income is defined as the gross income of a FSC attributable to foreign trading gross receipts. Foreign trade income includes both the profits earned by the FSC itself from exports and commissions earned by the FSC from products or services exported by others.

All foreign trade income, other than exempt foreign trade income, would be treated as income effectively connected with the conduct of a trade or business conducted through a permanent establishment within the United States. Furthermore, foreign trade income would be treated as derived from sources within the United States rather than as foreign source income. Thus, foreign trade income other than exempt foreign trade income would be taxed currently and treated as U.S. source income for purposes of the foreign tax credit limitation. This nonexempt foreign trade income would be either 6/23 or 66 percent of foreign trade income, depending on the pricing method used in arriving at foreign trade income.

A FSC may not credit or deduct foreign income, war profits, or excess profits taxes paid or accrued with respect to foreign trade income (whether exempt or nonexempt). The corporate shareholder of a FSC would be not eligible for a deemed-paid foreign tax credit with respect to foreign trade income. Two new categories of income would each be subject to separate foreign tax credit limitations (like DISC distributions under current law): (1) taxable income attributable to foreign trade income (at the FSC level), and (2) distributions from a FSC or former FSC out of earnings and profits attributable to foreign trade income (at the level of the FSC's shareholder). By virtue of these separate limitations, no increase in the FSC's foreign source income in the general "all other" category would result from foreign trade income.

Foreign trading gross receipts

In general, foreign trading gross receipts would mean the gross receipts of a FSC which are attributable to the export of certain goods and services (similar to the qualified gross receipts of a DISC under present law). Foreign trading gross receipts of a FSC are the gross receipts which are (1) from the sale, exchange or other disposition of export property, (2) from the lease or rental of export property for use by the lessee outside the United States, (3) for services which are related and subsidiary to the sale, exchange, disposition, lease or rental of export property, (4) for engineering or architectural services for construction projects located outside the United States, or (5) for the performance of managerial services that relate to the production of gross receipts.

For the FSC to have foreign trading gross receipts, two additional requirements must be met—the foreign management and foreign economic process requirements. (These requirements do not apply to small FSCs, described below.) A FSC would be treated as having foreign trading gross receipts only if the management of the corporation during the taxable year takes place outside the United States and only if the economic processes with respect to particular transactions take place outside the United States. (The management test applies to functions of the FSC for the taxable year. In contrast, the economic process test generally applies to every transaction on a transaction-by-transaction basis).

Foreign management.—The requirement that the FSC be managed outside the United States would be treated as satisfied for a particular taxable year if (1) all meetings of the board of directors of the corporation and all meetings of the shareholders of the corporation are outside the United States, (2) the principal bank account of the corporation is maintained outside the United States at all times during the taxable year and, (3) all dividends, legal, and accounting fees, and salaries of officers and members of the board of directors of the corporation disbursed during the taxable year are disbursed out of bank accounts of the corporation outside the United States.

Foreign economic processes.—Economic processes are treated as taking place outside the United States if two requirements are met. The first requirement is that, with respect to any transaction, the

FSC must participate outside the United States in the solicitation (other than advertising), the negotiation or the making of the contract relating to the transaction. This test can be met if either the FSC or any person acting under contract with the FSC has performed one or more of these activities outside the United States.

The second requirement is that the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50 percent of the total direct costs incurred by the FSC with respect to the transaction (or that the FSC meet an alternative 85-percent test, described below).

The term "total direct costs" (the denominator of the fraction) means, with respect to any transaction, the total direct costs incurred by the FSC attributable to the activities relating to the disposition of export property. These activities are those performed at any location within or without the United States by the FSC or any person acting under contract with the FSC. The term "foreign direct costs" (the numerator of the fraction) means the portion of the total direct costs incurred by the FSC which are attributable to activities performed outside the United States. Although the activities must be performed outside the United States, either the FSC or any person acting under contract with the FSC may perform the activities.

For purposes of the foreign direct-cost test, the costs of five activities relating to the disposition of export property are considered. The activities are (1) advertising or sales promotion, (2) the processing of customer orders and the arranging for delivery (outside the United States) of the export property, (3) transportation from the time of acquisition by the FSC to the delivery to the customer, (4) the determination and transmittal of the final invoice or statement of account and the receipt of payment, and (5) the assumption of credit risk. In the case of a commission relationship, the transportation test is determined from the beginning of the commission relationship rather than from the time of acquisition by the FSC.

The requirement that the foreign direct costs incurred by the FSC equal or exceed 50 percent of the total direct costs incurred by the FSC attributable to a transaction may be met by an alternative 85 percent test. Under this alternative test a corporation would be treated as satisfying the requirement that economic processes take place outside the United States if the foreign direct costs incurred by the FSC attributable to any two of the five activities relating to disposition of the export property equal or exceed 85 percent of the total direct costs of at least two of those five activities.

For example, if the foreign direct costs (incurred by a FSC with respect to a transaction) attributable to advertising and sales promotion, and the assumption of credit risk are 85 percent or more of the total direct costs of these activities, the foreign direct cost test would be satisfied. With respect to this transaction, none of the direct costs of the other activities, for example, the processing of customer orders and arranging for delivery outside the United States of the export property, need be foreign direct costs.

Burden of proof.—The burden of proof with respect to the foreign management and economic process requirements would be shifted to the Secretary of the Treasury if a written statement addressing the issue has been filed by an officer of the corporation. The statement to be filed with the Secretary must be made by an officer of the FSC who is a citizen and resident of the United States, and must be made under penalty of perjury. Furthermore, the statement must declare that the corporation meets the economic process requirements and the foreign management requirements and must specify how the requirements have been met for the particular transactions.

Excluded receipts.—Certain receipts are not included in the definition of foreign trading gross receipts. First, certain receipts are excluded on the basis of use; also, subsidized receipts and certain receipts from related parties are excluded. Examples of such receipts include the receipts of a FSC from a transaction (1) if the export property or services are for ultimate use in the United States or are for use by the United States and the use by the United States is required by law or regulation, (2) if the transaction is accomplished by a subsidy granted by the United States, or (3) if the receipts are from another FSC which is a member of the same controlled group.

Second, one-half of the receipts from military property are excluded from the definition of foreign trading gross receipts.

Third, investment income and carrying charges are excluded from the definition of foreign trading gross receipts. Carrying charges would mean not only amounts normally considered carrying charges but also any amount in excess of the price for an immediate cash sale and any other unstated interest. Thus, a taxpayer could not artificially increase foreign trade income through hidden carrying charges or unstated interest.

Income attributable to excluded receipts would not be foreign trade income and, therefore, no portion of such income would be exempt; furthermore, a corporate shareholder would not get a dividends-received deduction for distributions attributable to such income. For example, investment income and carrying charges would be included in the taxable income of the FSC and, therefore, subject to full U.S. tax. Distributions to a corporate shareholder from earnings and profits attributable to the investment income and carrying charges would be fully taxed again (to the corporate shareholder) because there would be no dividends-received deduction. In other words, the investment income and carrying charges would be subject to tax at the FSC level, the corporate shareholder level and, like all other dividends from the corporate shareholder to its individual shareholders, also at the individual level. At the FSC level, investment income would be eligible for foreign tax credits.

Transfer pricing rules

The pricing principles that govern the determination of the taxable income of a FSC are intended to comply with the GATT rules. If export property is sold to a FSC by a related person, the taxable income of the FSC and the related person is based upon a transfer price determined under an arm's-length pricing approach or under one of two formulae which are intended to approximate arm's-length pricing. Taxable income may be based upon a transfer price that allows the FSC to derive taxable income attributable to the sale in an amount which does not exceed the greatest of: (1) 1.83

percent of the foreign trading gross receipts derived from the sale of the property; (2) 23 percent of the combined taxable income of the FSC and the related person (these two pricing rules are termed the administrative pricing rules); and (3) taxable income based upon the actual sales price, but subject to the rules provided in section 482. Neither administrative pricing rule can cause a loss to the related supplier while the FSC is earning a net profit.

In order to use the special administrative pricing rules, a FSC must meet two requirements. The first requirement is that *all* of the activities with respect to which the direct costs are taken into account for the 50 percent foreign direct costs test must be performed by the FSC or by another person acting under contract with the FSC. These five activities are advertising and sales promotion, processing of customer orders and arranging for delivery of the property, transportation, billing and receipt of payment, and the assumption of credit risk. The second requirement for use of the administrative pricing rules is that *all* of the activities relating to the solicitation (other than advertising), negotiation and making of the contract for the sale must be performed by the FSC (or by another person acting under contract with the FSC). These two requirements can be met wherever the activities are performed. The activities do not have to be performed outside the United States. It is only necessary that the activities be performed by the FSC or by another person acting under contract with the FSC.

To summarize, to be treated as having foreign gross receipts and hence foreign trade income, the foreign costs of certain activities relating to the disposition of export property must be substantial (either 50 percent of the cost of all five activities or 85 percent of the cost of two of the activities). To use the administrative pricing rules, all five of the activities must be performed by the FSC or by another person acting under contract with the FSC. Furthermore, other activities (solicitation, negotiation, and making of the contract of sale) must be performed by the FSC or by another person acting under contract with the FSC.

Distributions to shareholders

Distributions to shareholders must be made first out of foreign trade income. The FSC may have income that is not foreign trade income, for example, investment income. Distributions would be treated as being made first out of earnings and profits attributable to foreign trade income, and then out of any other earnings and profits. Any distribution made by a FSC which is made out of earnings and profits attributable to foreign trade income to a shareholder which is a foreign corporation or a nonresident alien individual would be treated as a distribution which is effectively connected with the conduct of the trade or business conducted through a permanent establishment of the shareholder within the United States. Thus, such distributions would be generally subject to Federal income tax.

Dividends received from a FSC

A domestic corporation would be allowed a 100 percent dividends-received deduction for amounts distributed from a FSC out of earnings and profits attributable to foreign trade income. Thus, there would be no corporate level tax on exempt foreign trade income and only a single-level corporate tax (at the FSC level) on foreign trade income other than exempt foreign trade income. To the extent a corporate shareholder of a FSC distributes dividends attributable to foreign trade income to its individual shareholders the amounts would be taxed. Likewise, noncorporate shareholders of a FSC would be taxed currently on all dividends received from a FSC.

A dividends-received deduction would not be allowed, however, for distributions attributable to other earnings and profits. These distributions would therefore be taxed currently to the shareholders, corporate or noncorporate, of the FSC.

Other definitions and special rules

Factoring of trade receivables.—The bill would add a new category of income to the definition of foreign personal holding company income (which is used in taxing income to the United States shareholders of foreign personal holding companies and controlled foreign corporations (under Subpart F)). This category of income is income from an account receivable or evidence of indebtedness arising out of the disposition of property described in section 1221(1) (which includes stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), or the performance of services, by a related person. This rule would apply whether or not the related person is a U.S. person. The effect of this rule is to treat factoring as a tax-haven activity under the Subpart F rules.

In addition, the bill would amend the definition of U.S. property (in Code sec. 956) to include any account receivable or evidence of indebtedness arising out of the disposition of property described in section 1221(1), or performance of services, by a related U.S. person. This rule would apply notwithstanding the rule of current law that excludes from the definition of "U.S. property" obligations of unrelated U.S. corporations. The effect of this amendment would be to treat this factoring activity like certain other transfers of cash from controlled foreign corporations to their U.S. shareholders.

Export property.—In general, the term export property means property manufactured or produced in the United States for sale, lease or rental in the ordinary course of trade or business for use outside the United States, and not more than 50 percent of the fair market value of which is attributable to articles imported into the United States.

The term export property does not include (1) property leased or rented by a FSC for use by any member of a controlled group of which the FSC is a member, (2) patents and other intangibles, (3) oil or gas or any primary product thereof, or (4) products the export of which is prohibited. Export property also excludes property designated by the President as being in short supply. Coal and uranium products specifically excluded from the definition of export property under the DISC rules would not be excluded under this bill, however.

Cooperatives.—Agricultural products marketed through cooperatives are subject to special rules. Fungible agricultural products marketed through pooling arrangements of an exempt farmers' cooperative are treated as meeting the requirements that they be export property to the extent that the products are sold for use outside the United States. Each member of the pool is considered as a producer of the property to the extent of his or her ratable share of the product based upon his or her contribution of products to the pool. The special rule does not apply to any products which are sold by the cooperative through a FSC or DISC of which the cooperative is a shareholder. A cooperative marketing the products of its patrons is treated as acting as the agent of the patrons regardless of any formal transfer of title to the cooperative.

Gross receipts.—In general, the term gross receipts means the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of a trade or business, and gross income from all other sources.

In the case of commissions on the sale, lease, or rental of property, the amount taken into account for purposes of these provisions as gross receipts would be the gross receipts on the sale, lease, or rental of the property on which the commissions arose.

Investment income.—For purposes of these provisions the term investment income means dividends, interest, royalties, annuities, rents (other than rents from the lease or rental of export property for use by the lessee outside the United States), gains from the sale or exchange of stock or securities, gains from futures transactions in any commodity, amounts includible in computing the taxable income of the corporation under the estate and trust rules and gains from the sale or disposition of any interest in an estate or trust.

Grouping of transactions.—Many of the tests required under the foreign management and economic processes requirement are to be applied on a transaction-by-transaction basis. However, regulations would provide that transactions may be grouped based upon product lines or recognized industry or trade usage. The regulations could permit different groupings for different purposes. Such flexibility may be important when grouping transactions for purposes of the direct-cost test, for example.

Controlled group of corporations.—A controlled group of corporations is defined as in section 1563(a) except that a 50 percent ownership test is substituted for the 80 percent test.

Foreign tax credit limitation of related parties.—The bill would provide a special rule governing the source of income earned by a person related (within the meaning of section 482) to a FSC from transactions giving rise to foreign trading gross receipts of a FSC. That related person's foreign source income from such a transaction could not exceed the amount which would be treated as foreign source income earned by that person if the analogous DISC pricing rule applied. For this purpose, the DISC gross receipts pricing rule of Code section 994(a)(1) is analogous to the bill's gross receipts pricing rule in proposed section 925(a)(1); the DISC combined taxable income pricing rule of Code section 994(a)(2) is analogous to the bill's combined taxable income pricing rule in proposed section 925(a)(2); and the DISC section 482 pricing rule of Code section

994(a)(3) is analogous to the bill's section 482 pricing rule in proposed section 925(a)(3).

This special rule governing the source of income and thus the foreign tax credit limitation of parties related to a FSC is necessary to prevent revenue loss. The table below illustrates the application of the bill absent this special rule to a FSC's parent with excess foreign tax credits that exports by selling to its FSC. The table presupposes that the 50 percent of the parent's income from the export sale is foreign source income (as might well be the case under Code sec. 863(b) absent the bill's special rule). It presupposes that the parent has sufficient excess foreign tax credits to offset U.S. tax on all the foreign source income from the export sale. It also presupposes that the export sale is subject to the bill's combined taxable income (CTI) rule (proposed section 925(a)(2)).

FSC—77/23 SPLIT OF CTI ABSENT RESOURCING RULE

(Exporter With Excess Foreign Tax Credits)

Parent		*FSC*	
U.S. source (taxable)	$38.50	Exempt	$17
Foreign source (exempt)	38.50	Taxable	6
	77.00		23

Taxable:	
U.S. source income of parent	$38.50
Taxable income of FSC	6.00
	44.50

Exempt:	
Foreign source income of parent	$38.50
Exempt in FSC	17.00
	55.50

Under current law, the parent's share of combined taxable income is $50 (as illustrated in the table in the Present Law section of this pamphlet). The parent's foreign source income might be $25 under present law. Exemption of $55.50 under the bill (absent the special rule) would exceed the combination of exemption and deferral of $42 for a parent of a DISC with excess credits under current law (with a 17 percent deferral rate).[38] To maintain parity with DISC, the bill would reduce the foreign source income of the parent in the example above from $38.50 to $25, which would result in an exemption of $42 (comparable to present law). The parent's U.S. source income would increase, under the special rule of the bill, from $38.50 to $52. The following table illustrates the effect of the bill's resourcing rule.

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[38] In the Present Law section of this pamphlet, the taxpayer with excess credits was taxable on $58: $25 of U.S. source income plus a $33 deemed DISC distribution, but paid no tax on $25 of foreign source income or on $17 deferred in the DISC.

FSC—77/23 Split of CTI With Resourcing Rule

(Exporter With Excess Foreign Tax Credits)

Parent		*FSC*	
U.S. source (taxable)	$52	Exempt	$17
Foreign source (exempt)	25	ECI	6
	77		23

Taxable:	
U.S. source income of parent	$52
ECI of FSC	6
	58

Exempt:	
Foreign source income of parent	$25
Exempt in FSC	17
	42

Participation in international boycotts.—The exempt foreign trade income of a FSC would be limited if the FSC participates in international boycotts and to the extent that any illegal bribe, kickback or other payment is made to an official employee or agent of a government. Regulations would provide rules similar to those that apply to the deemed distributions of a DISC under section 995(b)(1)F).

Election.—A corporation could elect to be treated as a FSC, or a small FSC, for a taxable year at any time during the 90-day period immediately preceding the beginning of the taxable year. The bill would provide that the Secretary of the Treasury has authority to consent to the making of an election at other designated times. The election would be made in a manner prescribed by the Secretary. The election would be valid only if all shareholders as of the first day of the first taxable year for which the election is effective consent to the election.

Small business

In order to provide relief for small businesses who may find the foreign presence and economic activity burdensome, the bill would provide two alternatives to the FSC: the interest charge DISC and the small FSC.

Interest charge DISC.—A DISC may continue to defer income attributable to $10 million or less of qualified export receipts. Deemed distributions relating to base period exports (the incremental rule) and to one-half of the DISC's income would be eliminated; thus, substantially all of the DISC's income attributable to $10 million or less of qualified export receipts could be deferred. However, unlike the present law DISC, an interest charge would be imposed on the shareholders of the DISC. The amount of the interest would be based on the tax otherwise due on the deferred income computed as if the income were distributed. The interest rate would be tied to the T-bill rate.

The tax that would otherwise be due on the deferred income, termed the shareholder's DISC-related deferred tax liability, means, with respect to the year of the shareholder, the excess of the tax liability for the year computed as if the deferred DISC income were included in income over the actual tax liability for the year. This amount would be computed without regard to carrybacks to such taxable year. The Secretary of the Treasury is directed to prescribe regulations to provide any adjustments necessary or appropriate in the case of net operating losses, credits, and carryovers.

Deferred DISC income generally means the excess of accumulated DISC income at the beginning of the taxable year over the amount by which actual distributions out of accumulated DISC income exceed the current year's DISC income (termed distributions-in-excess-of-income). For shareholders of the DISC whose taxable year is different from that of the DISC, deferred DISC income is measured from the computation year; with respect to any taxable year of the shareholder, the computation year is the taxable year of the DISC which ends within the shareholder's preceding taxable year.

The rate of interest imposed on the shareholder's DISC-related deferred tax liability is determined by reference to a base period T-bill rate; this would mean the annual rate of interest that is equivalent to the average investment yield of U.S. T-bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with the close of the taxable year of the shareholder. The Secretary of the Treasury would be expected to publish this rate in October of each year. The interest a taxpayer is required to pay under this provision would be due at the same time the shareholder's regular tax is required to be paid.

Taxable income of the DISC attributable to qualified export receipts that exceed $10 million would be deemed distributed. Thus, if export receipts exceed $10 million, the DISC would not be disqualified; there would merely be no deferral of income attributable to the excess receipts. DISCs which are members of the same controlled group would be treated as a single corporation for purposes of the $10 million-rule.

Small FSC.—A FSC could elect to be a small FSC with respect to a taxable year provided that it is not a member at any time during the taxable year of a controlled group of corporations which includes a FSC (unless the other FSC has also made a small FSC election).

In order to have foreign trading gross receipts, a small FSC need not meet the foreign management and foreign economic process requirements. However, in determining the exempt foreign trade income of a small FSC, any foreign trading gross receipts that exceed $2,500,000 would not be taken into account. No exception to the requirements for use of the administrative pricing rules is provided for small FSCs. Because these activities may be performed by the FSC or by another person acting under a contract with the FSC and need not be performed outside the United States, this may not be as onerous a requirement to small exporters as the foreign management and economic process requirements would be.

All small FSCs which are members of the same controlled group would be treated as a single corporation.

If the foreign trading gross receipts of a small FSC exceed the $2,500,000 limitation, the corporation may select the gross receipts to which the limitation is allocated. This provision would allow a taxpayer to choose, for example, to allocate the limitation to gross receipts attributable to transactions where the profit margin is high; in this case, the amount of exempt income would be greater than if the limitation were allocated to low margin transactions.

Taxable year of DISC and FSC

The taxable year of any DISC or FSC would be required to conform to the taxable year of the majority shareholder (or group of shareholders with the same taxable year) as determined by voting power. Special rules are provided for where more than one shareholder or shareholder groups have the highest percentage of voting power, and for subsequent changes of ownership.

Transition rules for DISCs

The taxable year of any DISC which begins before January 1, 1984 and which would otherwise include January 1, 1984 would close on December 31, 1983. To the extent that any underpayment of estimated tax is created or increased by this provision, no penalty would be imposed.

Accumulated DISC income which is derived before January 1, 1984 would be exempt from tax. This result is achieved by treating such income as previously taxed income.

To alleviate the hardship that may result from deemed distributions to a shareholder of a DISC that would otherwise be recognized in income in a later year by the shareholder, a special rule provides for a spread of such income over four years. Deemed distributions from a DISC attributable to income derived by the DISC in the taxable year of the DISC which begins in 1983 after the date in 1983 on which the taxable year of the shareholder begins would be treated as received by the shareholder in four equal installments; the installments would be treated as received on the last day of each of the four taxable years of the shareholder which begins after the shareholder's taxable year beginning in 1983.

For example, a DISC's taxable year ends January 31 and the corporate shareholder of the DISC is a calendar year taxpayer. In 1983, the corporate shareholder would include in income the deemed distributions from the DISC for the DISC's year ending on January 31, 1983 and, under the bill (absent the four-year spread), the deemed distributions for the 11-month taxable year ending on December 31, 1983. Almost two years of deemed distributions would be includible in income in 1983. Under the bill, the deemed distributions for the 11-month period ending December 31, 1983, would be spread over a four-year period and includible in the income of the shareholder in 4 equal installments: on December 31 of 1983, 1984, 1985, and 1986.

Transfers from DISC to FSC

Except to the extent provided in regulations to be prescribed, section 367 (which taxes some transfers of appreciated assets to foreign corporations) would not apply to transfers made generally before January 1985 to a FSC of qualified export assets held on August 4, 1983, by a DISC in a transaction to which section 351 or 368(a)(1) apply.

Effective date

The provisions of the bill would generally apply to transactions after December 31, 1983, in taxable years ending after such date. The provisions relating to treatment of trade receivables would apply to accounts receivable and evidences of indebtedness acquired by the foreign corporation after August 4, 1983 (the date of introduction).

IV. ECONOMIC ANALYSIS OF S. 1804

When the DISC legislation was adopted in 1971, the U.S. merchandise trade balance was in deficit for the first time since the Second World War. Despite enactment of the DISC legislation, the merchandise trade deficit is larger than it was in 1971, and continues to be an important issue of Congressional concern. There has been considerable controversy over the extent to which DISC has actually stimulated exports and whether the associated revenue loss is justified. In this section, the effectiveness of the DISC legislation is analyzed and compared with the substitute foreign sales corporation (FSC) proposal as introduced in S. 1804 and H.R. 3810.

Effectiveness of DISC

The DISC legislation provides an indefinite deferral of tax on a portion of qualified export income which is allocated to a DISC. This effectively reduces the rate of tax on the income from capital used in the production of exports distributed through DISCs. To the extent that the tax benefit is passed through to foreign customers (as a lower dollar price) and the exchange rate is fixed, DISCs increase the competitiveness of U.S. exports. The primary rationale for enacting the DISC legislation was to stimulate exports, and, thereby, the economy and employment, and also to remove a perceived tax disadvantage of domestic exporters. Congress was concerned that tax incentives provided by other countries gave foreign producers, including U.S.-controlled foreign subsidiaries, an advantage over domestic producers, and created a tax incentive for U.S. companies to manufacture offshore.[39]

The Revenue Act of 1971 includes a requirement that the Secretary of the Treasury submit an annual report to Congress analyzing the operation and effect of the DISC provisions. Table 1 summarizes the revenue and export effects of the DISC legislation presented in the annual DISC Reports from 1972 through 1981. According to the Treasury Reports, the increase in merchandise exports attributable to the DISC legislation amounts to 3-4 percent of total U.S. merchandise exports. The revenue cost of the DISC program grew to an estimated $1.65 billion in 1981. The revenue cost per $100 of export increase was estimated to average $40 in 1973-1976 and $20 in 1977-1981. Table 1 also shows that the merchandise trade deficit was four times larger in 1981 than it was in 1972, the first year of DISC operation. These trade deficits are the result of a combination of factors including: the rapid rise in the world market price of petroleum, the 1980 grain embargo, and the conduct of macroeconomic policy both in the United States and abroad.

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[39] H. Rep. No. 533, 92d Cong., 1st Sess. 58 (1971); S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971).

Table 1.—DISC Report Estimates: 1972-1981

[Dollar amounts in millions]

DISC year	DISC export increase		DISC revenue cost		Merchandise trade balance
	Amount	Percent of total exports	Amount	Percent of export increase	
1972	NA	NA	$35	NA	−$6,416
1973	$2,180	3.1	730	33	911
1974	2,900	2.9	1,120	39	−5,343
1975	2,380	2.2	1,150	48	9,047
1976	2,860	2.5	1,220	43	−9,306
1977	3,900	3.2	750	19	−30,873
1978	3,640	2.6	730	20	−33,759
1979	4,500–7,000	2.4–3.8	990	14–22	−27,346
1980	6,200–9,400	2.8–4.2	1,410	15–23	−25,338
1981	7,200–11,000	3.0–4.7	1,650	15–23	−27,889

Sources: Department of the Treasury, 1972–81 DISC Reports; Council of Economic Advisors, *Economic Report of the President* (1983).

The Treasury estimates of the cost effectiveness of DISC have been criticized in a study by Price Waterhouse.[40] The Price Waterhouse study concludes that the DISC legislation is a self-financing tax cut, that is, a tax cut which raises revenue. Unlike the Treasury Report, the Price Waterhouse study assumes that the additional exports attributable to DISC do not draw productive resources such as labor and capital from other sectors of the U.S. economy. Rather, the Price Waterhouse study adopts the position that the DISC export increase represents a net addition to GNP which generates new tax revenues (to the extent that tax on this income is not deferred). The Price Waterhouse position is most likely to be accurate when the economy is in a recession and there are idle resources.

Some economists have criticized the DISC program on the grounds that it is inefficient and does not necessarily increase U.S. employment.[41] They point out that the fixed exchange rate system was replaced by a flexible rate system shortly after the DISC program was enacted. Under the current system of floating exchange rates, export incentives are rendered ineffective, to some extent, by appreciation of the dollar. Such appreciation reduces the dollar price of imports and raises the foreign currency price of exports.

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[40] Price Waterhouse, *Economic Impacts of the Domestic International Sales Corporation (DISC) Tax Provisions*, A study prepared for the American Business Conference, *et. al.*, (April 15, 1982).

[41] *See* J.G. Gravelle and D.W. Kiefer, *Deferral and DISC: Two Targets of Tax Reform*, Congressional Research Service (February 3, 1978) and D.L. Brumbaugh, *DISC: Effects, Issues and Proposed Replacements*, Congressional Research Service (April 5, 1983).

Thus there may be an expansion of employment in the export sectors, and a decline in employment in import-competing sectors such as the automobile industry. Due to adjustments in the exchange rate over time, export incentives may fail to have a sustained impact on *net* U.S. exports or employment. For this reason, some economists have argued that a change in macroeconomic policy to reduce the high value of the dollar is a better method of resolving the trade deficit than import barriers or export incentives.

In addition to any direct revenue costs associated with the DISC legislation, there may be a hidden efficiency cost to the U.S. economy.[42] This efficiency loss is attributable to the misallocation of resources between export and non-export sectors of the economy. U.S. income may decline both because resources are not deployed in the sectors where their productivity is highest, and because the dollar appreciation which may result from the operation of the DISC legislation reduces income from offshore investments.[43]

Some economists fault the design of the DISC program on the ground that it is inadequately targeted. They argue that exports are unlikely to increase in sectors where DISC tax benefits are not passed forward as lower prices but are instead passed back to shareholders as higher profits.[44] The more difficult it is for firms to enter an industry, the less likely it is that competitive market forces will ensure that DISC benefits result in lower export prices. On these grounds, some have argued that the Export-Import Bank is a more effective program than DISC since the benefits it provides go primarily to the more competitive export sectors.

Another frequent criticism of the DISC legislation is that the benefits are heavily concentrated in the hands of a small number of exporters. According to the 1981 Treasury Report, 35.2 percent of the tax benefit of the DISC program went to 26 DISCs, or 0.3 percent of the total 8665 DISCs in that year. Almost half of the tax benefit (49 percent) went to 89 DISCs, or 1 percent of the total. The main reason for this concentration of DISC benefits is that a few firms account for a large share of total exports. Indeed, the 1981 Report indicates that, per dollar of export income, small DISCs receive more tax savings than large DISCs. This shows the effect of the incremental provisions which, since 1976, have limited deferral to the excess of current period over base period DISC income; DISCs with $100,000 of income or less are exempted from these provisions.

When the DISC legislation was adopted in 1971, Congress was concerned that tax incentives provided by other countries gave foreign manufacturers an advantage over U.S. firms. However, over the last 10 years, there have been numerous changes in the U.S. corporate tax, including: restoration of the investment credit in 1971, liberalization of the investment credit in 1975, reduction of the corporate tax rate from 48 to 46 percent in 1979, and acceleration of depreciation allowances with the introduction of the accelerated capital recovery system (ACRS) in 1981. Since the U.S. investment credit and ACRS depreciation are generally available only on domestic capital, the tax disadvantage of manufacturing in the United States may have declined, if not reversed, since the enactment of the DISC legislation.

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[42] J. Mutti and H. Grubert, *DISC and its Effects*, National Bureau of Economic Research Summer Institute on International Studies (December 1982).

[43] Foreign asset holdings of U.S. investors yield foreign currency income. When the dollar appreciates, the value of this foreign investment income drops in dollar terms.

[44] *See* T. Horst and T. Pugel, "The Impact of DISC on the Prices and Profitability of U.S. Exports," *J. of Public Economics*, Vol. 7, 73-87 (1977).

The GATT permits member countries to exempt (or rebate) direct taxes, such as value added taxes, on exported items; but GATT prohibits the exemption (or rebate) of direct taxes, such as corporate income and payroll taxes.[45] Critics of the GATT rules have argued that DISC is necessary to offset the disadvantage U.S. exporters confront as a result of the fact that the United States relies relatively more on direct taxes than its trading partners. However, the difference in relative tax burdens on U.S. and foreign goods is generally due to differences in direct rather than indirect taxes. U.S. exports and locally produced foreign goods are both free of U.S. indirect taxes (e.g., state and local sales taxes), and subject to foreign indirect taxes (e.g., value added taxes) in the country where the goods are used. Similarly, imports and domestically produced goods consumed in the United States are both free of foreign indirect taxes and subject to U.S. indirect taxes. Thus, in general, if U.S. goods have a tax disadvantage in the world market, this results from higher direct taxes (e.g., payroll, property, and income taxes) in the United States compared to our trading partners.

Economic Comparison of FSC and DISC

In a territorial tax system, a nation does not assert the right to tax income attributable to economic activities that take place outside the nation's borders; such income is exempt from the nation's tax. In December 1981, the GATT Council adopted the position that territorial taxation does not constitute an export subsidy provided that arm's-length pricing rules are used to distribute income between a firm and its foreign branches and subsidiaries. The GATT Council did not at that time resolve the longstanding allegation of certain countries that DISC is an illegal export subsidy. In March 1983, the Administration proposed to replace DISC with a new tax system for exports—FSC. Under the FSC proposal, domestic firms which export through an FSC would be exempt from U.S. tax on a portion of the export income attributable to the FSC.

Table 2 shows the computation of U.S. tax for a small DISC, a "typical" DISC, and a FSC. In each case it is assumed that the parent corporation, in conjunction with its DISC or FSC, has $100 of combined gross receipts, $80 of total deductions, and $20 of combined taxable income. In the DISC examples, the $20 of combined taxable income is allocated half ($10) to the parent and half to the DISC.[46] In the small DISC case (less than $100,000 of DISC taxable income), 42.5 percent (i.e., 50 percent less the 15 percent cutback enacted in the Tax Equity and Fiscal Responsibility Act of 1982) of

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[45] Although there is some ambiguity, direct taxes are generally defined to include: corporate and personal income, payroll, property, wealth, gift, estate, and other taxes which are imposed on the individual (or entity) that is meant to bear the burden. Indirect taxes are generally defined to include: sales, value added, excise, and other specific taxes which are imposed at one level of production or distribution but are meant to be shifted forward to the ultimate consumer.

[46] Under these facts, the 50 percent of combined taxable income allocation method results in less tax than either the 4 percent of gross receipts method or the arm's-length method.

DISC taxable income is deferred from taxation, and 57.5 percent ($5.75) is deemed distributed to the parent. Total taxable income is equal to the parent's allocated income ($10) plus the deemed distribution ($5.75), or $15.75. Thus for a company with a small DISC, tax liability is $7.25 (.46 x $15.75), and the effective tax rate on export income is 36.2 percent ($7.25/$20).[47]

Table 2.—Comparison of Export Income Taxation Under DISC and the FSC Proposal

Item	Small DISC	Typical DISC	Proposed FSC
1. *Combined account:*			
Gross export receipts	$100.00	$100.00	$100.00
Total deductions	80.00	80.00	80.00
Combined taxable income	20.00	20.00	20.00
2. *FSC account:*			
Gross FSC receipts	NA	NA	100.00
Total deductions	NA	NA	95.40
Acquisition cost (transfer price)	NA	NA	94.40
Other FSC costs	NA	NA	1.00
FSC net income	NA	NA	4.60
Exempt income	NA	NA	3.40
Effectively connected income	NA	NA	1.20
3. *DISC account:*			
DISC taxable income	10.00	10.00	NA
DISC deferred income	4.25	3.40	NA
Deemed distribution	5.75	6.60	NA
4. *Parent account:*			
Gross receipts	100.00	100.00	94.40
Total deductions	80.00	80.00	79.00
Net income before allocation	20.00	20.00	15.40
Total taxable income	15.75	16.60	16.60
Net income after allocation	10.00	10.00	15.40
FSC effectively connected income	NA	NA	1.20
DISC deemed distribution	5.75	6.60	NA
U.S. tax	7.25	7.64	7.64
Effective U.S. tax rate (percent)	36.2	38.2	38.2

The deferral rate for a "typical" DISC is lower than for a small DISC since deferral is limited to 42.5 percent of the excess of current DISC taxable income over base period income. A typical DISC, according to Treasury data, has a deferral rate of 34 percent, so that $3.40 is deferred from tax, and $6.60 is deemed distributed to the parent. Total taxable income is equal to the parent's allocated income ($10) plus the deemed distribution ($6.60), or $16.60. Thus for a company with a typical DISC, tax liability is $7.64 (.46 x $16.60), and the effective tax rate on export income is 38.2 percent ($7.64/$20).

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[47] In this example it is assumed that there are no credits and that tax depreciation equals economic depreciation.

The computation of tax for a parent selling through a FSC is shown in the third column of Table 2. In this example it is assumed that the FSC is incorporated in a jurisdiction which imposes negligible tax on the income allocated to the FSC. It is also assumed that the FSC performs certain economic activities such as sales promotion and arranging for transportation so that the $100 of export receipts qualifies as foreign trading gross receipts under the proposal. The cost of conducting these economic activities in the FSC accounts for $1 of the total $80 cost of sales and operations.

Under the proposal, one of two methods of apportionment (in addition to the arm's-length method) may be used to determine the FSC's share of the $20 of combined taxable income: (1) 23 percent of combined taxable income, and (2) 1.83 percent of gross receipts. In this example, the income method results in the largest apportionment of income to the FSC: $4.60 (.23 x $20). Hence, the transfer price from the parent to the FSC is established as $94.40 ($100-$1-$4.60) since this is the price which results in exactly $4.60 of foreign trading income. The remaining $15.40 ($20-$4.60) is allocated to the parent company and is subject to U.S. tax. According to the proposal, a portion (17/23) of the FSC's income is exempt from U.S. tax, and the remaining portion (6/23) is "effectively connected" income which is subject to U.S. tax. Total taxable income is equal to the parent's allocated income ($15.40) plus the effectively connected income ($1.20), or $16.60. Thus for a company with a FSC, tax liability is $7.64 (.46 x $16.60), and the effective tax rate on export income is 38.2 percent ($7.64/$20).

Table 2 (which uses Treasury assumptions) shows that the effective U.S. tax rate on export income is 38.2 percent under the FSC proposal as well as for a company with a typical DISC. However, companies with small DISCs, which are exempt from the incremental rule, are taxed more lightly under current law at an effective rate of 36.2 percent. Under the incremental rule of current law, small, new, or rapidly growing DISCs enjoy a higher deferral rate and a lower effective tax rate than large, older, or slow growing DISCs. Since there are no incremental provisions in the FSC proposal, adoption of S. 1804 would tend to hurt small, new, and rapidly growing DISCs which have an above average deferral rate, and benefit large, older, and slow growing DISCs which have a below average deferral rate. Table 3 shows that the rapidly growing export sectors which might tend to be hurt by the FSC proposal include: chemicals, fabricated metal products, electrical machinery, and scientific instruments. The slow growing export sectors which would most likely benefit from the FSC proposal include: minerals, food, lumber, and leather products. (The minerals industry would also benefit because the FSC proposal would provide benefits to products on which depletion deductions are allowable, other than oil and gas related products. Thus, coal and uranium, which are excluded from DISC, would be eligible for FSC benefits.)

Table 3.—Growth Rate of DISC Exports by Sector

[Dollar amounts in billions]

Sector	1977 gross receipts	1981 gross receipts	Growth rate of gross receipts (percent)
Total	$82.681	$154.078	16.8
Nonmanufactured Products	23.997	42.517	15.4
Agriculture	22.512	40.401	15.7
Mineral products	.767	1.063	8.5
Other	.716	1.053	10.1
Manufactured Products	58.684	111.561	17.4
Ordnance and accessories	.225	.197	−3.3
Food and kindred products	3.154	4.204	7.4
Tobacco manufactures	.452	1.110	25.2
Textile mill products	.837	1.829	21.6
Apparel, etc	.171	.582	35.8
Lumber, etc. ex. furniture	2.093	2.884	8.3
Furniture and fixtures	.018	.081	45.6
Paper and allied products	1.458	3.115	20.9
Printing, publishing, etc	.209	.392	17.0
Chemicals & allied products	6.926	16.728	24.7
Rubber and misc. products	.565	1.085	17.7
Leather & leather products	.635	.837	7.1
Stone, clay, glass & cement	.445	.882	18.7
Primary metal	1.086	3.262	31.6
Fabricated metal products	1.860	4.264	23.0
Machinery, ex. electrical	13.214	22.549	14.3
Electrical machinery	6.118	14.360	23.8
Transportation equipment	15.161	21.796	9.5
Scientific instruments	2.804	6.027	21.1
All other manufacturing	1.254	2.379	17.4

Source: Department of the Treasury, 1977 and 1981 Annual DISC Reports.

Some have suggested that because the FSC proposal lacks an incremental rule, it is likely to be less cost-effective, in terms of revenue loss per dollar of additional exports, than the DISC program. However, it is not certain that the incremental rule has increased the long-run efficiency of the DISC program. First, under the incremental rule, an increase in exports yields tax-deferred income in the current year but reduces tax-deferred income in future years. This occurs because, after four years, the original increase in exports enters into base period gross receipts and decreases the amount of incremental DISC income eligible for deferral.[48] Second, for exporters with slow growing or declining sales, the incremental rule could reduce DISC benefits to the point where it is more advantageous to manufacture offshore than in the United States. For these reasons, the incremental rule, enacted in 1976, may have failed to increase the efficiency of the DISC program compared to a non-incremental system with the same revenue cost (e.g., the FSC proposal).

An important difference between DISC and the FSC substitute is that a FSC must be incorporated abroad and may be subject to foreign tax. Under the FSC proposal, the foreign taxes paid by a FSC would not be credited against U.S. tax liability. In addition, the FSC must maintain an office and a permanent set of books outside the United States and must engage in some of the economic activities related to the export receipts of the parent company. Only small FSCs (under $2.5 million of annual gross receipts) are exempted from the requirement of conducting significant offshore economic activities. The additional expenses (including any foreign taxes) associated with operating a FSC would reduce the net benefit from exporting through a FSC. Thus, for the same revenue loss, the FSC legislation may stimulate fewer additional exports than DISC since firms would only utilize a FSC if the tax savings cover the transaction costs of the offshore corporation.

Another important difference between DISC and the FSC substitute is that DISC provides a deferral of tax, rather than an exemption from tax. To qualify for tax deferral, the asset test requires that a DISC invest 95 percent of its accumulated deferred income in qualified export assets such as: export trade receivables, producer loans, inventory, and Export-Import Bank (Ex-Im) obligations. For many companies the restrictions on the use of these funds are not a significant burden. Receivables can be financed and the parent can obtain the current use of funds through producer loans. But to the extent that the accumulated tax-deferred income must be invested in Ex-Im obligations, which have a low yield and do not enable the parent corporation to use the funds in normal operations, the asset test imposes more of a burden. According to the 1981 DISC Report, 6 percent (i.e., $1.2 billion) of total DISC assets were invested in Ex-Im obligations. (Adoption of the FSC proposal would eliminate the captive market for low yield Ex-Im obligations and, consequently, reduce the ability of the Ex-Im Bank to finance exports.) For some companies, the asset test may become sufficiently onerous that there would no longer be an incentive to export through a DISC. Since the FSC proposal is an exemption system, there is no asset test. Thus FSC may be a more potent export incentive in cases where the asset test would have reduced DISC benefits.

Another important practical difference between DISC and the FSC substitute arises from elimination of the assets test and the gross receipts test. The consequences of failure of a DISC to meet these tests are severe; all previously deferred income may become taxable. In contrast, even if a FSC fails to meet the requirements to be a FSC, or to meet the economic process tests with respect to a transaction, no such harsh result follows; current benefits may be lost but not the benefits from prior years.

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[48] *See* Appendix C of the Treasury's 1976 DISC Report. There it is argued that if export receipts grow faster (slower) than the cost of capital, then the incremental rule makes DISC less (more) cost-effective than it would be without the incremental rule.

APPENDIX A:

SIDE-BY-COMPARISON OF DISC AND FSC PROVISIONS

Item	DISC	FSC
1. Entity subject to Federal income tax	No.	Yes (exclusion for exempt foreign trade income).
2. Type of entity	(a) A corporation which is incorporated under the laws of any State;	(a) A corporation which is incorporated under the laws of a foreign country or U.S. possession;
	(b) that has one class of stock, par or stated value of $2,500;	(b) that has no preferred stock;
	(c) no restriction on number of shareholders;	(c) that has no more than 25 shareholders;
	(d) no Board of Directors restriction.	(d) that has at least one nonresident individual on Board of Directors.
3. Election	Yes.	Yes.
4. Taxable year	Need not conform to taxable year of shareholders.	Must conform to taxable year of majority shareholder.
5. Qualified export assets and gross receipts requirement	Yes. Failure to satisfy requirements results in taxation of previously deferred income and may result in termination of DISC.	No.
6. Foreign presence requirement	No.	Yes.
7. Excluded corporations	Generally not a tax-exempt corporation, personal holding company, financial institution, insurance company, regulated investment company, or S corporation.	Not a member of a controlled group which includes a DISC.
8. Type of income	95 percent must be qualified gross receipts.	Exclusion from income is limited to exempt foreign trade income.

SIDE-BY-COMPARISON OF DISC AND FSC PROVISIONS—Continued

Item	DISC	FSC
9. Export receipts	Qualified gross receipts are, generally gross receipts from the sale, lease or rental of export property and from related services; and certain dividends, interest, and gross receipts from qualified assets (other than export property).	Foreign trading gross receipts are generally the same as DISC qualified gross receipts; but do not include dividends, interest, and gross receipts from certain property that is not export property. To qualify foreign management and foreign economic process requirements must be met.
10. Excluded receipts	Generally not: (a) gross receipts for use in U.S. that is subsidized or used by the U.S. under law requiring such use; and (b) receipts from a related DISC.	(a) Same as DISC, and (b) receipts from a related FSC.
11. Export property	(a) Property manufactured, produced or grown in the U.S. for use or disposition outside the U.S.	(a) Same as DISC, and (b) fungible agricultural products sold through an exempt farmers' cooperative.
12. Excluded property	Generally not: property for use by a related corporation, intangibles, depletable products, property the export of which is prohibited, and property in short supply.	Same as DISC, except oil and gas are the only excluded depletable products (coal and uranium are not excluded).
13. Intercompany pricing rules	Transfer price based on: (a) 4 percent of qualified export receipts; (b) 50 percent of combined taxable income; or (c) sales price actually charged but subject to sec. 482.	Transfer price based on: (a) 1.83 percent of foreign trading gross receipts; (b) 23 percent of combined taxable income; or (c) same as in DISC. To use administrative pricing rules ((a) or (b) above) for a transaction, the FSC must perform certain activities with respect to the transaction.
14. Taxation of income to shareholders	DISC not subject to tax, but shareholders are subject to tax on certain deemed distributions and actual distributions out of deferred income.	FSC subject to tax. Corporate shareholder receives a 100 percent dividend-received deduction for dividends attributable to foreign trade income.

15. Disposition of stock	Gain recognized as a dividend to the extent of accumulated DISC income.	No similar provision needed because there is no deferred income.
16. Distributions	Treated as: (a) first out of previously taxed income; (b) second, out of accumulated DISC income; and (c) third, out of any other earnings and profits.	Treated as: (a) first out of earnings and profits attributable to foreign trade income; and (b) second, out of any other earnings and profits.
17. Maximum tax benefit	Deferral of tax on 1.7 percent of gross receipts or 21.25 percent of combined taxable income (subject to reduction by incremental rule).	Tax exemption on 1.35 percent of gross receipts or 17 percent of combined taxable income.
18. Small business	Exemption from incremental rule if taxable income is $100,000 or less; phaseout of exemption from incremental rule between $100,000 and $150,000.	(a) Interest-charge DISC (applicable to gross receipts of $10 million or less) essentially same as DISC, except—no incremental rule; no deemed distributions, and an interest charge is imposed on deferred income. (b) Small FSC exception for gross receipts of $2,500,000 or less from certain foreign presence and foreign economic activity requirements.

APPENDIX B:

SELECTED GATT DOCUMENTS

1. Article XVI of the General Agreement

Subsidies

SECTION A — SUBSIDIES IN GENERAL

1. If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory, it shall notify the Contracting Parties [throughout this Appendix, the term "Contracting Parties," with initial capital letters, refers to the general membership of GATT] in writing of the extent and nature of the subsidization, of the estimated effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory and of the circumstances making the subsidization necessary. In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the Contracting Parties, the possibility of limiting the subsidization.

SECTION B—ADDITIONAL PROVISIONS ON EXPORT SUBSIDIES

2. The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement.

3. Accordingly contracting parties should seek to avoid the use of subsidies on the export of primary products. If, however, a contracting party grants directly or indirectly any form of subsidy which operates to increase the export of any primary product from its territory, such subsidy shall not be applied in a manner which results in that contracting party having more than an equitable share of world export trade in that product, account being taken of the shares of the contracting parties in such trade in the product during a previous representative period, and any special factors which may have affected or may be affecting such trade in the product.

4. Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any prod-

uct other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957 no contracting party shall extend the scope of any such subsidization beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies.

5. The Contracting Parties shall review the operation of the provisions of this Article from time to time with a view to examining its effectiveness, in the light of actual experience, in promoting the objectives of this Agreement and avoiding subsidization seriously prejudicial to the trade or interests of contracting parties.

2. Article XXIII of the General Agreement

Nullification or Impairment

1. If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of

(a) the failure of another contracting party to carry out its obligations under this Agreement, or

(b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or

(c) the existence of any other situation,

the contracting party may, with a view to the satisfactory adjustment of the matter, make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it.

2. If no satisfactory adjustment is effected between the contracting parties concerned within a reasonable time, or if the difficulty is of the type described in paragraph 1(c) of this Article, the matter may be referred to the Contracting Parties. The Contracting Parties shall promptly investigate any matter so referred to them and shall make appropriate recommendations to the contracting parties which they consider to be concerned, or give a ruling on the matter, as appropriate. The Contracting Parties may consult with contracting parties, with the Economic and Social Council of the United Nations and with any appropriate inter-governmental organization in cases where they consider such consultation necessary.

If the Contracting Parties consider that the circumstances are serious enough to justify such action, they may authorize a contracting party or parties to suspend the application to any other contracting party or parties of such concessions or other obligations under this Agreement as they determine to be appropriate in the circumstances. If the application to any contracting party of any concession or other obligation is in fact suspended, that contracting party shall then be free, not later than sixty days after such action is taken, to give written notice to the Executive Secretary to the Contracting Parties of its intention to withdraw from this Agreement and such withdrawal shall take effect upon the sixtieth day following the day on which such notice is received by him.

3. Report of the GATT Panel on DISC: Conclusions [49]

67. The Panel started by examining the effects of the DISC legislation in economic terms. The Panel concluded that it conferred a tax benefit and that this benefit was essentially related to exports. The Panel considered that if the corporation income tax was reduced with respect to export related activities and was unchanged with respect to domestic activities for the internal market this would tend to lead to an expansion of export activity. Therefore, the DISC would result in more resources being attracted to export activities than would have occurred in the absence of such benefits for exports.

68. The Panel noted that the United States Treasury had acknowledged that exports had increased as a result of the DISC legislation and the Panel considered that the fact that so many DISCs had been created was evidence that DISC status conferred a substantial benefit.

69. The Panel noted that the DISC legislation was intended, in its own terms, to increase United States exports and concluded that, as its benefits arose as a function of profits from exports, it should be regarded as an export subsidy.

70. The Panel examined whether a deferral of tax was "a remission" in terms of item (c) or "an exemption" in terms of item (d) of the illustrative list of 1960 (BISD, 9 Suppl. p. 186).

71. The Panel was not convinced that a deferral, *simply* because it is given for an indeterminate period, was equal to a remission or an exemption. In addition it noted that the DISC legislation provided for the termination of the deferral under specified circumstances. The Panel further noted, however, that the deferral did not attract the interest component of the tax normally levied for late or deferred payment and therefore concluded that, to this extent, the DISC legislation constituted a partial exemption which was covered by one or both of paragraphs (c) and (d) of the illustrative list.

72. The Panel noted that the contracting parties that had accepted the 1960 Declaration had agreed that the practices in the illustrative list were generally to be considered as subsidies in the sense of Article XVI:4. The Panel further noted that these contracting parties considered that, in general, the practices contained in the illustrative list could be presumed to result in bi-level pricing, and considered that this presumption could therefore be applied to the DISC legislation. The Panel concluded, however, from the words "generally to be considered" that these contracting parties did not consider that the presumption was absolute.

73. The Panel considered that, from an economic point of view there was a presumption that an export subsidy would lead to any or a combination of the following consequences in the export sector: (a) lowering of prices, (b) increase of sales effort and (c) in-

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[49] This is an excerpt from GATT Doc. L/4422 (Nov. 2, 1976). The Panel's conclusions began with paragraph 67; the preceding 66 paragraphs set forth background information and the arguments of the parties.

crease of profits per unit. Because the subsidy was both significant and broadly based it was to be expected that all of these effects would occur and that, if one occurred, the other two would not necessarily be excluded. A concentration of the subsidy benefits on prices could lead to substantial reductions in prices. The Panel did not accept that a reduction in prices in export markets needed automatically to be accompanied by similar reductions in domestic markets. These conclusions were supported by statements by American personalities and companies and the Panel felt that it should pay some regard to this evidence.

74. The Panel therefore concluded that the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4.

75. The Panel examined the significance of the various options under the DISC legislation for the allocation of profits from export sales between parent companies and DISCs, and concluded that these could influence the size of the exemption.

76. The Panel concluded that the provision allowing the deduction of certain shipping costs by DISCs (on the condition that exports be carried in United States vessels), and the provision allowing 10 percent of export promotion expenses to be assigned as a deductible expense to a DISC would appear to confer additional pecuniary benefits.

77. The Panel considered that, as it had found the DISC legislation to constitute an export subsidy which had lead to an increase in exports, it was also covered by the notification obligation contained in Article XVI:1.

78. While the Panel noted that primary product exports were eligible for DISC benefits and had been traded substantially through DISCs, it did not examine whether the benefits would result in the United States obtaining a disproportionate share of the world market in terms of Article XVI:3.

79. The Panel noted the United States argument that it had introduced the DISC legislation to correct an existing distortion created by tax practices of certain other contracting parties. However, the Panel did not accept that one distortion could be justified by the existence of another one and considered that, if the United States had considered that other contracting parties were violating the General Agreement, it could have had recourse to the remedies which the General Agreement offered. On the other hand, the fact that tax practices of certain other countries had been in force for some time without being the subject of complaints was not, in itself, conclusive evidence that there was a consensus that they were compatible with the General Agreement.

80. In the light of the above and bearing in mind the precedent set by the Uruguayan case (BISD, 11 Suppl. p. 100),[50] the Panel found that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement.

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[50] That case stands for the proposition that where there is a clear infringement of the provisions of the General Agreement, or in other words, where measures are applied in conflict with the provisions of GATT, there is prima facie nullifacation or impairment of benefits.

4. Report of the GATT Panel on French Tax Practices: Conclusions (Excerpts) [51]

"The Panel noted that the particular application of the territoriality principle by France allowed some part of export activities, belonging to an economic process originating in the country, to be outside the scope of French taxes. In this way France has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries."

"The Panel found that however much the practices may have been an incidental consequence of French taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market. The Panel also considered that the fact that the practices might also act as an incentive to investment abroad was not relevant in this context."

"The Panel also noted that the tax treatment of dividends form abroad [taxation at a nominal rate] ensured that the benefits referred to above were fully preserved."

". . . [T]he Panel concluded that there was a partial exemption from direct taxes. The Panel further concluded that the practices were covered by one or both items (c) and (d) of the illustrative list of 1960 (BISD, 9 Suppl. p. 186)."

"The Panel added that bi-level pricing had probably occurred. . . , [and] concluded that the French tax practices in some cases had effects which were not in accordance with French obligations under Article XVI:4."

"The Panel noted that the allocation of profits between companies and their foreign operations was made in accordance with the arm's-length pricing principle but that there were formal exceptions[52] to this principle and concluded that the benefit would be increased to the extent that arm's-length pricing was not fully observed."

"The Panel was of the view that, given the size and breadth of the export subsidy, it was likely that it had led to an increase in French exports in some sectors and, although the possibility could not be ruled out that the tax arrangements would encourage production abroad and a decrease in exports in other sectors, nonetheless concluded that it was also covered by the notification obligation of Article XVI:1."

"The Panel found that there was a *prima facie* case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement."

5. 1979 Subsidies Code—Footnote 2 to Item (e)

In adopting the Subsidies Code in 1979, the GATT signatories included the following footnote to explain Item (e) of the Illustrative

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[51] This is a series of excerpts from "Income Tax Practices Maintained by France," GATT Doc. No. *L/4423* (*Nov. 2, 1976*).

[52] Notes of the French Administration in 1959 and thereafter had indicated that the French authorities did not apply arm's-length pricing rules strictly to export transactions (Panel report at paragraph 26).

List of export subsidies, which lists exemption, remission or deferral, specifically related to exports, of direct taxes:

"The signatories recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The signatories further recognize that nothing in this text prejudges the disposition by the Contracting Parties of the specific issues raised in GATT document L/4422 [the DISC case].

The signatories reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any signatory may draw the attention of another signatory to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the signatories shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of signatories under the General Agreement, including the right of consultation created in the preceding sentence.

"Paragraph (e) is not intended to limit a signatory from taking measures to avoid the double taxation of foreign source income earned by its enterprises or the enterprises of another signatory.

"Where measures incompatible with the provisions of paragraph (e) exist, and where major practical difficulties stand in the way of the signatory concerned bringing such measures promptly into conformity with the Agreement, the signatory concerned shall, without prejudice to the rights of other signatories under the General Agreement or this Agreement, examine methods of bringing these measures into conformity within a reasonable period of time. . . ."

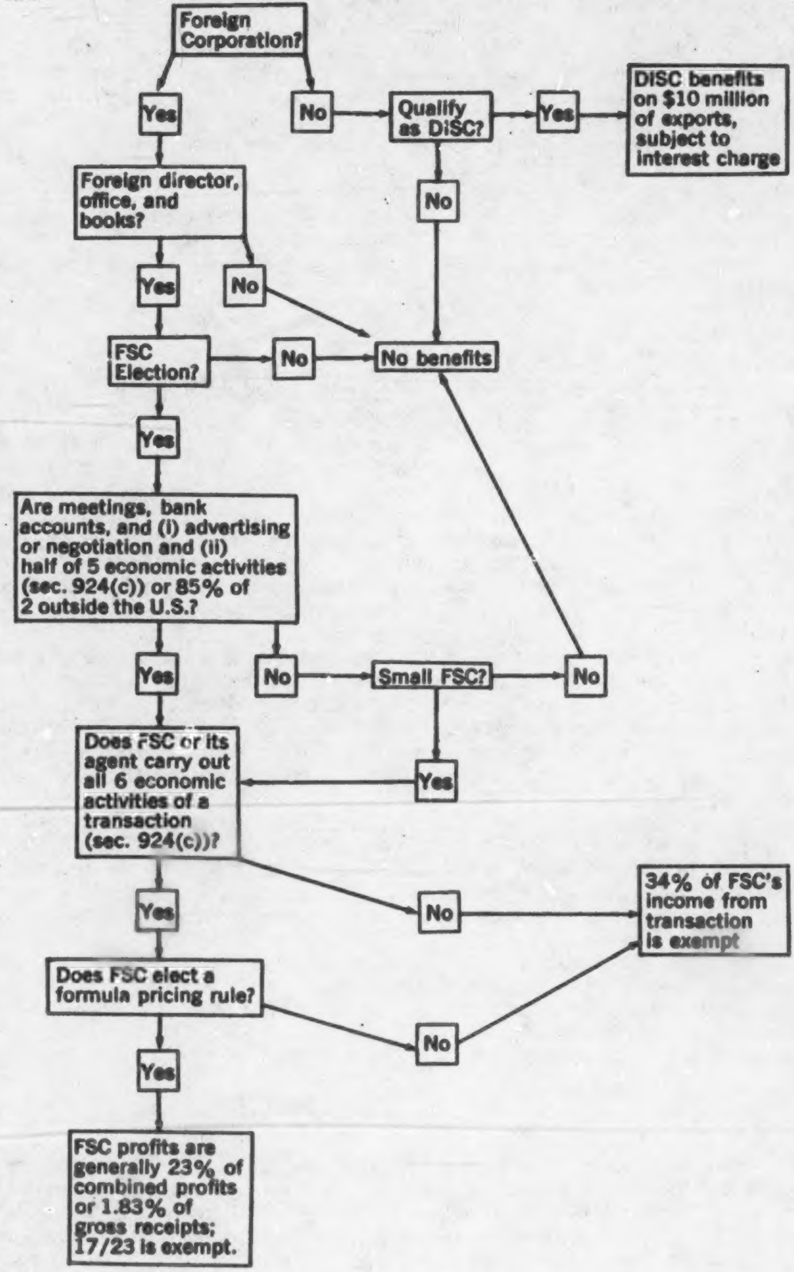
At a meeting in December, 1981, the GATT Council adopted all four panel reports governing the tax practices of Belgium, France, the Netherlands, and the United States, but with a qualification. The text of the agreement is reproduced herein.

6. GATT Council Adoption of Panel Reports

The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's-length pricing be observed, i.e., prices for goods in transactions between exporting enterprises and foreign buyers under their or the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.

APPENDIX C

FLOW CHART: QUALIFICATION FOR BENEFITS UNDER S. 1804


Foreign Corporation?
Yes
No
Qualify as DISC?
Yes
DISC benefits on $10 million of exports, subject to interest charge
No
Foreign director, office, and books?
Yes
No
FSC Election?
No
No benefits
Yes
Are meetings, bank accounts, and (i) advertising or negotiation and (ii) half of 5 economic activities (sec. 924(c)) or 85% of 2 outside the U.S.?
Yes
No
Small FSC?
No
Yes
Does FSC or its agent carry out all 6 economic activities of a transaction (sec. 924(c))?
Yes
No
34% of FSC's income from transaction is exempt
Does FSC elect a formula pricing rule?
No
Yes
FSC profits are generally 23% of combined profits or 1.83% of gross receipts; 17/23 is exempt.

PREPARED STATEMENT OF SENATOR STEVE SYMMS

Mr. Chairman, I would like to commend you for holding hearings this morning on the new Foreign Sales Corporation proposal.

As you know, I am a co-sponsor of S. 1804 and it is my belief that prompt enactment of S. 1804 is needed to help U.S. companies compete in the world markets, which in turn would help reduce the U.S. trade deficit.

Since the GATT has ruled DISC to be an illegal export subsidy, it is possible that the GATT Council could provide the European Community with the authorization to take retaliatory action against United States exports due to the continued existence of the DISC tax provisions. If retaliatory action is taken against U.S. exports, our agriculture, machinery, and chemical exports might be jeopardized.

The legislation is clearly GATT legal. It has been carefully formulated to comply with our GATT obligations and prompt enactment will remove a major stumbling block in our economic relations with more than 80 countries which, together with the United States, support the GATT system.

Before I close, Mr. Chairman, I would like to add that there are some minor adjustments that need to be made to the legislation to ensure that it is beneficial to small businesses. In particular, I believe that interest charge DISC provision needs to be changed so that the provisions we enact will at least be as beneficial as under the present DISC rules.

Thank you.

PREPARED STATEMENT OF SENATOR CHARLES GRASSLEY

Mr. Chairman, thank you for pursuing this legislation promptly by scheduling these hearings. The Department of Treasury, the United States Trade Representative, and the authors of this legislation have worked to devise a system which achieves DISC's objectives, yet complies with the General Agreement on Tariffs and Trade. While the legality of the old DISC system was never officially determined, I have been advised that our European trading partners find the old DISC system extremely distasteful and will pursue sanctions if revision is not forthcoming. I want the EEC to take note that Congress does sincerely address violations of GATT alleged by Europeans. I wish the EEC was as forthright when the U.S. points out EEC violations.

The elimination of DISC would reduce some of our price advantage on agricultural exports. In the Department of Treasury's 1981 Annual Report to Congress on the Operation and Effect of the Domestic International Sales Corporation Legislation, Treasury estimates that the repeal of DISC would decrease agricultural exports 400 to 600 million dollars. Treasury also reports that agricultural DISCs were responsible for gross export receipts of $42 billion in 1981. Obviously, DISC is important to American agriculture.

One of my primary concerns in evaluating legislation which will substitute DISC is whether or not a FSC (foreign sales corporation) can achieve the same objectives as its predecessor. USTR has endeavored to keep the FSC proposal revenue neutral, not disadvantage users of the current DISC system, comply with GATT and create a small business exception. My questions to witnesses, my focus will be to discover if these objectives have been met.

The sponsors of this bill in conjunction with the Administration and the business community have worked hard to devise a substitute for DISC. It is my hope this legislation will be acceptable to the European Community and finally resolve the international controversy surrounding DISC.

"I look forward to the testimony of the witnesses.

STATEMENT OF SENATOR DAVID L. BOREN

Mr. Chairman, since it was enacted into law, the Domestic International Sales Corporation (DISC) has served as probably our most significant export incentive. Exports attributable to DISC have grown from $1.9 billion in 1972 to $11 billion in 1981. Since every billion dollars in exports supports about 30,000 U.S. jobs, about 330,000 jobs are dependent upon exports through DISC. Seventy-two percent of all manufactured exports are channelled through one of the 17,000 existing DISCs, which has contributed to the $157 billion rise in exports of U.S. manufactures between 1971 and 1980. This is obviously an important tool in stimulating exports which, in turn, create jobs.

As the sponsor of a predecessor of the Foreign Sales Corporation (FSC) proposal, I have worked with the Administration as well as with a broad range of interested groups to ensure that this essential incentive is preserved. The FSC bill attempts to cause the fewest possible changes in existing business practices while putting us on a more equal plane with our competitors.

There are several elements of the FSC proposal which are essential to its effectiveness. The bill would forgive tax on DISC income that has already benefitted from tax deferral. This provision must be kept intact. It would be wrong to ignore the original intent of Congress when DISC was first enacted by altering the approach used in S. 1804, as some have suggested. Exports of coal and other hard minerals should be included as export property eligible for FSC benefits. Any negative revenue impact this plan might have must be kept to a minimum.

Primarily, I believe we must guarantee that the incentives provided in the FSC proposal are at least equal to those in the present law. Foreign Sales Corporations must serve as an incentive to all exporters who have utilized DISC in the past. Small exporters who have used DISC should be accommodated in this proposal so that they can continue to have access to the same export incentives available to large exporters.

The foreign presence requirements in the FSC proposal would prevent many smaller firms, which have taken advantage of DISC, from utilizing FSC benefits. The small business provisions in the bill reflect a sensitivity to this problem and serve as a good first step towards assisting these firms. I intend to introduce amendments to modify this proposal in such a way that will make small business compliance with FSC rules less cumbersome and thereby permit our small exporters to benefit as they have under DISC. Considering the steady deterioration of America's balance of trade, we cannot afford to delay our efforts to strengthen this essential export promotion tool.

Senator **Danforth**. Mr. Lighthizer, Mr. Pearlman, and Mr. O'Day. Do you want to start, Bob?

STATEMENT OF THE HONORABLE ROBERT E. LIGHTHIZER, DEPUTY U.S. TRADE REPRESENTATIVE, OFFICE OF THE U.S. TRADE REPRESENTATIVE

Mr. **Lighthizer**. Thank you, Mr. Chairman.

It is a pleasure to appear before the Finance Committee to explain why the Reagan administration strongly supports the expeditious passage of S. 1804, the Foreign Sales Corporation Act of 1983.

I would like to present a short verbal statement now and submit a more lengthy statement for the record, if that is agreeable to the committee.

If S. 1804 is enacted, it will replace the domestic international sales corporation legislation with a tax vehicle which will have the same effect on our export competitiveness as the DISC, while at the same time meeting our obligations under the General Agreement on Tariffs and Trade—the GATT.

In discussing the FSC bill with the business community, I am frequently asked why change the DISC? Many businessmen say that the DISC has worked well, that it helps to offset tax advantages enjoyed by our trading competitors, and that with the record of trade deficits that we are now experiencing we should not do anything to hamper our export competitiveness. There is considerable merit in this view.

However, we now face a paradox, which undermines the force of these arguments. The DISC, which is intended to help our export competitiveness, instead now threatens to damage our exports as our trading partners prepare to retaliate if we maintain DISC in its current form. Other countries regard the DISC as an export subsidy that violates our GATT obligations.

Because of this universally held international opinion, we are now threatened with specific retaliation in the form of new foreign restrictions against our exports if we continue the DISC. The committee should be aware, Mr. Chairman, that the administration came to the decision to change the DISC only after every effort had been made to convince our trading partners that DISC is, in effect, GATT consistent.

But the fact remains that negotiations during the Tokyo round were very prejudicial to the DISC, leaving our trading partners with the impression that the United States agreed that DISC is GATT illegal. And the territorial system of taxation is not.

In other words, we inherited a wide spread of negative international attitude toward the DISC. The only solution now is to conform our tax treatment of export income to the GATT accepted territorial standard. This is essentially what S. 1804 does.

Most importantly, it will do this without increasing the tax burden on our exporters to the detriment of our international competitiveness. As you know, Mr. Chairman, there is considerable concern in the Congress about whether enactment of S. 1804 will resolve the U.S.-EC dispute over the DISC once and for all. Because of this congressional concern, Ambassador Brock asked his counterpart in the European Commission for a statement by the Community regarding its position on this legislation.

I should note that it is highly unusual for us to make such a request because we are normally reluctant to subject the legislative process to international scrutiny.

But in light of the very legitimate congressional concern on this particular issue, we made an exception to general policy. The EC reaction is presently being informally discussed. The Community has several reservations particularly on the forgiveness of the accumulated deferred taxes and on the territorial provisions of the bill.

We do not, however, interpret this as a totally negative reaction to the FSC bill. The EC has indicated some flexibility and we intend to press in the next few weeks for a definitive position. In fact, Ambassador Brock is now meeting with high level EC officials to discuss the issue as well as other matters.

We will, of course, keep the committee informed on the progress of our discussions with the Community.

In closing, Mr. Chairman, I would like to reiterate our strong desire that S. 1804 move quickly through the Congress. The threat of retaliation if the DISC remains in its current form is real. Enactment of S. 1804 will remove this immediate threat. Thank you, Mr. Chairman.

Senator DANFORTH. Thank you, Mr. Ambassador.

[The Ambassador's prepared statement follows:]

TESTIMONY OF AMBASSADOR ROBERT E. LIGHTHIZER

INTRODUCTION

Mr. Chairman, it's a pleasure to appear before the Finance Committee to explain why the Reagan Administration strongly supports the expeditious passage of S. 1804—the Foreign Sales Corporation (FSC) Act of 1983. If S. 1804 is enacted, it will replace the Domestic International Sales Corporation (DISC) legislation with a tax vehicle which will have the same effect on our export competitiveness as the DISC while, at the same time, meeting our obligations under the General Agreement on

Tariffs and Trade—the GATT. The Administration believes that enactment of this bill is essential if we are to avert a real threat of retaliation, and if we are ever to make progress toward resolving one of our longest, outstanding trade disputes.

WHY CHANGE THE DISC

In discussing the FSC bill (S. 1804) with the business community, I'm frequently asked, Why change the DISC? Many businessmen say that the DISC has worked well, that it helps to offset tax advantages enjoyed by our trade competitors, and, with the record trade deficits we are now experiencing, we should not do anything to hamper our export competitiveness.

There is considerable merit in these views. However, we now face a paradox which undermines the force of these arguments. The DISC, which is intended to help our export competitiveness, instead now threatens to damage our exports as our trading partners prepare to retaliate if we maintain DISC in its current form. Other countries regard the DISC as an export subsidy that violates our GATT obligations. Because of this universally-held international opinion, we are now threatened with specific retaliation in the form of new foreign restrictions against our exports if we continue the DISC.

Maintenance of the DISC already has seriously impaired our effectiveness in challenging subsidies and other unfair trade practices of other nations that are damaging to our exports. Other governments are hesitant to enter agreements with us to discipline their subsidies because they believe we are maintaining an illegal subsidy under DISC. Likewise, our efforts to use and improve the dispute settlement procedure under GATT are undermined by the impression held by many nations that we are unwilling to abide by the GATT decision on DISC.

Enactment of S. 1804 will bring the DISC into conformity with our GATT obligations, thereby avoiding a real threat to our exports. Most importantly, it will do this without increasing the tax burden on our exporters to the detriment of our international competitiveness.

Despite this explanation of why we should change the DISC, some of our critics still characterize the GATT aspects of this matter as just sterile theoretical debate among diplomats and technicians, posing no real threat of practical harm to our trade interests. Nothing yet has happened that could be labelled as specific retaliation against DISC, so why change just to improve our debating posture?

I think that such views are wishful thinking, and I'd like to review briefly the GATT background to show why.

GATT HISTORY

When this Administration assumed office in January, 1981, the DISC already had a long and painful history in GATT. Our trading partners began objecting to the DISC on GATT grounds almost from the moment the DISC was enacted in 1971. After bilateral consultations failed to resolve the issue in 1972, the EC filed a formal GATT complaint. The United States promptly filed counter-complaints against certain tax practices of France, Belgium, and the Netherlands. Panels were established to hear each of these complaints and to render recommendations to the GATT Council.

The panel reports, finally issued in 1976, found the DISC and the tax practices of France, Belgium, and the Netherlands to constitute export subsidies in contravention of Article XVI:4 of the GATT. The EC could not accept these findings, and the United States refused to accept condemnation of only the DISC. After a period of stalemated debate, both parties looked to the negotiation of the Subsidies Code during the Tokyo Round as the appropriate forum for negotiating a mutually acceptable settlement.

As members of this Committee are now well aware, the Subsidies Code negotiations during the Tokyo Round were highly prejudicial to the DISC. It would serve little purpose for me to relate to you my impression of what actually happened during the Tokyo Round or to try to point fingers. The record of the negotiations does not present a definitive accounting.

What remains significant, however, is that during the Tokyo Round EC officials were misled to believe that the United States agreed that the DISC was inconsistent with the GATT and that the EC tax systems were not. Though this understanding was unilaterally repudiated by officials of the Carter Administration after the Tokyo Round, the impression unfortunately remains that the United States agreed that the DISC violated the GATT.

This impression was the dominate view internationally when this Administration took office in January of 1981. Despite this widespread negative view toward the

DISC, we attempted to save it from final condemnation in the GATT. Specifically, we sought to achieve a compromise under which the panel's four reports on the DISC and the related tax practices of France, Belgium, and the Netherlands could be adopted by the GATT Council, while still preserving our argument that the DISC was consistent with the GATT.

This compromise is embodied in the GATT Understanding of December 6, 1981. It is based on the principle that countries have no obligation to tax income generated outside their territories, as long as this income is determined through objective arm's-length pricing rules. In other words, it recognizes that the territorial tax system is acceptable under GATT. This Understanding cleared the way for the adoption of the panel reports and later provided the basis for the FSC proposal.

Throughout the first half of 1982, the United States continued to defend the DISC. We urged that, since the DISC generally provided less of an export incentive than the territorial system of taxation, it too should be acceptable to the GATT Council under the December 1981 Understanding. The EC, bolstered by the past history on this matter, argued that the United States had already admitted that the DISC is GATT-illegal and agreed to bring it into conformity. Failure to do so now not only violated the GATT, but contravened those previous understandings.

The United States argued vigorously and at length in defense of the DISC, but received no support from other GATT members. The EC arguments proved convincing to all our trading partners members. They quickly came to the opinion that we were just stalling.

The situation grew increasingly tense in the spring of 1982 when the EC began calling for authority from the GATT Council to retaliate against U.S. exports. The EC's request for retaliatory authority was deferred by the Council through the summer months. But, it had become clear to us by the fall that the widespread exasperation with the U.S. position carried a real risk that there would, in fact, be retaliation against a substantial volume of our trade. So the Administration decided it was in the U.S. interest to replace the DISC and formally agreed, in October 1982, to ask the Congress for such a replacement. S. 1804 is the Senate response to this request.

OUR MANDATE

The Cabinet Council on Commerce and Trade (CCCT) immediately began considering the DISC in the fall of 1982. A debate ensued on the form of the DISC replacement. In November 1982, the President directed a task force with representatives from USTR, Treasury, and Commerce to develop a DISC replacement which included four primary features. It must: (1) be GATT consistent; (2) be revenue neutral; (3) maintain the same level of benefit for U.S. exporters as existed under the DISC; and (4) avoid disadvantaging small and medium-sized exporters.

It is extremely difficult to meet all four of these objectives in one tax vehicle. But we believe that the FSC bill does. We fully support its passage.

FSC'S CONFORMITY WITH THE GATT

One of the most controversial issues regarding the FSC bill is whether it is GATT-legal. We believe that it is and I'd like to explain to the Committee why.

The FSC bill is designed to conform to the December 1981 Understanding adopted by the GATT Council which recognizes that there is no GATT obligation for an exporting country to tax income arising from economic processes outside its own borders. This Understanding includes three principle elements—a foreign presence requirement, an arm's-length pricing requirement, and a double taxation provision.

The first element of the Understanding, the foreign presence requirement, states that ". . . economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4." S. 1804 includes numerous features to meet the GATT requirement that there be economic processes outside our borders in order to qualify for a tax exemption.

First, it replaces the DISC with the FSC—a Foreign Sales Corporation—through which export sales would be made. To establish foreign identity, the FSC must be incorporated outside the customs territory of the United States, it must maintain a permanent set of books in that foreign office, and it must have at least one nonresident of the United States on its board of directors. These foreign identity standards are described in Section 922 of the bill.

Secondly, S. 1804 requires that certain foreign management activities be undertaken outside the United States under Section 924. These activities include:

—holding all board of director's and shareholders' meetings outside the United States;
—maintaining the FSC's principal bank account outside the United States; and
—paying dividends, legal fees, accounting fees and salaries out of a foreign bank account.

Finally, S. 1804 requires that the FSC undertake significant economic activity overseas to earn tax exempt income. This is an important feature that distinguishes the FSC from the DISC. Much of the GATT criticism of DISC has focused on the absence of a requirement in the DISC law for foreign activities.

By constrast to the DISC, S. 1804 requires that a FSC:
—participate outside the United States in either the solicitation, negotiation, or the making of a sales contract; and
—perform activities outside the United States that give rise to either 50 percent of all the direct costs incurred by the FSC for performance of five functions, or 85 percent of all the direct costs of any two of the five functions.

These cost tests ensure the performance of a sufficient amount of foreign activity to qualify it as a legimate foreign economic process under GATT.

The second element of the GATT Understanding, the arm's-length requirement, states ". . . that Article XVI:4 requires that arm's-length pricing be observed . . ." There are no precise guidelines on arm's-length pricing in GATT or the Subsidies Code, and the Subsidies Code itself seems to recognize the difficulties of achieving total precision. To satisfy GATT norms, the FSC bill includes transfer pricing rules in Section 925 which are based on generally recognized arm's-length pricing principles.

Under Section 925, a taxpayer can use Section 482 of the Internal Revenue Code—an internationally recognized arm's-length pricing rule to derive a transfer price. Alternatively, recognizing the difficulty for both taxpayer and tax administrator to assess each individual transaction, the taxpayer can use one of the two administrative pricing rules. However, if either of these rules is used, the FSC must perform a series of activities. These include:
—the solicitation, negotiation, and making of the sales contract;
—advertising and sales promotion;
—the processing of customer orders and the arranging for delivery;
—transportation to the customer;
—the determination and transmittal of a final invoice or statement of account and the receipt of payment; and
—the assumption of credit risk.

We believe that this amount of activity justifies in GATT terms the income allocation provided for under the administrative pricing rules.

The third element of the GATT Understanding, the double taxation provision, states that GATT ". . . Article XVI:4 does not prohibit the adoption of measures to avoid the double taxation of foreign source income." In accordance with this provision, S. 1804 excludes from taxation a certain portion of the FSC's income. Only a portion of the FSC's income is excluded because the FSC is not required to perform all its activities outside the United States. Some of the FSC's income is connected to U.S. activity and it is, therefore, taxable. In addition, a tax credit will not be allowed for taxes paid by the FSC to foreign governments.

REACTION OF OUR TRADING PARTNERS

I would be remiss, Mr. Chairman, if I did not address the question of how our trading partners feel about the FSC bill. In general, the international community universally welcomes the decision taken by the United States to replace the DISC legislation.

That being said, I should advise you that the European Community (EC) has expressed some reservations regarding the bill. For example, the Community has argued that tax forgiveness of the accumulated DISC deferred income constitutes a new GATT-illegal export subsidy.

We have argued that the forgiveness merely gives effect to the indefinite nature of the deferral when it was originally granted under DISC. In this sense, it is a past practice associated with the DISC. Because the aim of the dispute settlement process in GATT is to seek discontinuance of GATT-illegal practices and not to provide compensation, we feel no obligation to tax the deferred earnings. Such taxation would be tantamount to paying the Community for the past damages of the DISC, a practice totally unprecedented in GATT.

The EC also has reservations about the GATT conformity of a partial territorial tax system, and of the foreign presence requirements as they relate to the tax exclusion. We believe that these reservations are not well founded and that the FSC is GATT defensible.

The EC's concerns over the tax forgiveness provision and their reservations on other elements of the bill should not be interpreted as a negative reaction to the bill. It would be highly unusual for any of our trading partners to accept the FSC bill as fully GATT consistent before it is enacted. Governments, including our own, do not give prior, blanket approval with regard to new and untested measures, particularly where the matter is complex.

Nevertheless, we will continue to press the Community for further clarification of its position. Ambassador Brock is now meeting with high level EC officials to discuss this issue, as well as other measures. We will, of course, keep the Committee informed of our discussions with the Community.

We also intend to continue consulting with our other trading partners. To the extent that they have valid concerns or constructive suggestions regarding the bill, we hope that they can be accommodated in the legislative process. To achieve this end, we will keep the Congress fully informed on our consultations with other governments.

I should note that we should not slow the legislative process because of the reservations that our trading partners have on this bill. As the bill moves through the legislative process, we will continue working with our trading partners in an effort to satisfy their concerns. However, to the extent we are unable to satisfy their concerns, we can expect a GATT challenge. But, we shouldn't delay because of some potential GATT action.

CONCLUSION

In summary, Mr. Chairman, I would like to convey the Administration's wholehearted support for S. 1804. Expeditious passage of the bill will forestall retaliation against our exports. Failure to pass the bill will surely result in renewed efforts to retaliate against us, and the liklihood is that such efforts will ultimately succeed.

Senator **DANFORTH**. Mr. Pearlman.

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. **PEARLMAN**. Thank you, Mr. Chairman.

It is a pleasure to be here this morning and to join my colleagues in strongly supporting S. 1804. I would like to spend my time this morning discussing some of the technical matters that we believe need some further attention as the bill moves forward.

In general, if a FSC organized outside the U.S. Customs territory meets the bill's so-called foreign presence and economic process requirements—requirements that are intended to assure that the level of foreign activity is consistent with our undertakings under the GATT—then earnings attributable to the FSC activities will not be taxed in the United States and dividends to a domestic corporate shareholder attributable to its export sales income will be eligible for 100 percent dividends received deduction.

Tax benefits of a FSC are limited to foreign trade income, that is, income earned from transactions involving certain export property and certain export related services. As I indicated, an important aspect of the bill is the foreign presence and foreign economic process requirements. These requirements mandate that certain basic corporate activities take place outside the United States, such as shareholder and board of director meetings; that certain financial activities take place outside the United States, such as the maintenance of a principal bank account and the payment of certain salaries and fees; and that certain sales activities take place outside the United States, such as promotional activities, sales order processing, transportation, and billing and financing.

Here the FSC is given considerable leeway in determining the extent and thus the nature of its foreign activity. We recognize that the manner of organization of the FSC and the degree of this activity required outside of the United States is of great interest to those businesses desirous of using the FSC. In order to explain our understanding of these requirements, we transmitted to the committee earlier this week an explanation of the principal operating provisions of the bill. We hope this explanation has assisted interested parties in analyzing and commenting on the bill.

Assuming that the FSC has export sales which meet the foreign economic process requirements, it must determine its foreign trade income. It may do so either by using the transfer pricing rules of section 482 or the administrative pricing rules under the bill.

Under the administrative pricing rules, the FSC may earn the greater of 23 percent of combined taxable income of it and its related supplier on an export transaction or 1.83 percent of the gross receipts on the transaction. If the section 482 rules are utilized to determine foreign trade income, 34 percent of the FSC foreign trade income will be deemed attributable to its foreign activities and therefore will be excluded from income. If the administrative pricing rules are utilized, seventeen-twenty-thirds of the foreign trade income will be excluded. In either case, the remainder of the foreign trade income, as well as all of the investment income of the FSC, will be subject to tax in the United States.

I would like to turn now to certain aspects of the bill for particular comment. First, the provisions dealing with small business. We recognize the particular problems small exporters may have in meeting the foreign presence and the foreign economic process requirements. Accordingly, the bill contains specific provisions designed to deal with the problems of small exporters.

If an FSC elects to apply the pricing and tax exemption rules to no greater than $2.5 million in gross export receipts, it need not meet the foreign management or foreign economic process requirements. In 1981, over one-half of the active DISC's had less than $2.5 million in export sales. Moreover, even in export intensive industries, on the average one-third or less of a manufacturer's output is export related. Thus, it is likely that firms with total sales of $7.5 million or more will not have greater than $2.5 million in export sales.

As a result, we believe the $2.5 million threshold should be of substantial benefit to a broad range of small businesses interested in utilizing FSC in connection with export activities.

A small exporter also has the option of retaining its DISC and deferring tax on income attributable to $10 million in gross export receipts provided that it pays interest to the Treasury on tax liabilities deferred after S. 1802 becomes effective.

We also think the elimination of the qualified export asset rules applicable to DISC will make administration of FSC much easier and less burdensome. Moreover, we are hopeful that firms will develop and provide expert overseas export services to small exporters, thereby making it possible both to satisfy the foreign economic process requirements and increase the small exporters' effectiveness in the highly competitive export market.

I would like to turn now to the likely use of tax havens as the jurisdictions in which to incorporate an FSC. Since the bill requires formation of the FSC outside the U.S. Customs territory, including U.S. possessions, it is likely that taxpayers will choose low or zero rate tax jurisdictions. The bill seeks to assure that organization and operation in a tax haven will not impede effective enforcement of the FSC provisions. The bill requires maintenance of detailed business records in the United States and requires tax of all of an FSC's passive income in the United States.

We remain concerned, however, with the perception that the bill might provide a windfall benefit to tax haven jurisdictions which have not participated in the growing international cooperation on exchange of information to which this administration is firmly committed. Therefore, we are desirous of working with the committee and the business community in making sure that the bill as ultimately enacted reflects our continued commitment to improve international tax administration and enforcement without unnecessarily undermining the effectiveness of the FSC.

We also have certain other matters which we believe require our attention. First, we believe that it is essential that the effective date of the legislation be prospective and thus we recommend that it be changed from December 31, 1983, to transactions completed after December 31, 1984.

Second, there are certain transitional rules that need to be developed, including those for long-term contracts.

Third, we recommend deletion from the bill of the extension of benefits to fungible agricultural products marketed through agricultural cooperatives. The current DISC provisions do not encompass such products and our review of this provision since the bill was introduced indicates the rather significant revenue loss to the tune of about $100 million per year will result if this provision is left in the bill. This detracts significantly from the revenue neutrality of the bill and also discriminates against agricultural products not marketed through cooperatives. Extension of the bill to all agricultural products would increase the revenue loss even further—indeed to an unacceptable level. Therefore, we recommend deletion of this provision from the bill, but we will continue to consider the effect of such a deletion on the competitive relationship between cooperatives and other private exporters.

Fourth, we recommend amendment to the bill to make sure that nonexempt foreign trade and other income of a FSC organized in the Virgin Islands be made subject to U.S. tax. This is needed because of a drafting oversight which will adversely affect the revenue neutrality of the bill.

Finally, just a few comments on the carrying charge and receivables provisions of the bill. In designing the exemption rate on foreign trade income, it was assumed that investment income now received by a DISC would be fully taxable in the United States. This again is important to the bill's revenue neutrality. It is important to make sure that a FSC does not earn investment income indirectly by charging a higher export price which contains an implicit carrying charge which could be in the form of unstated interest. Therefore, the bill makes it clear that carrying charges including unstated interest will not be exempt from tax. We will implement these rules, imputing an interest component on a deemed cash sale.

It is also important to make sure that export receivables now held by DISC's are not transferred to controlled foreign corporations at a discount without current U.S. tax, directly or to a shareholder under subpart F. This, too, goes to the revenue neutrality of the bill. We also believe that any time a controlled foreign corporation finances a related party receivable, the factoring income should be subject to tax under subpart F.

Thus, we strongly support the related party factoring provision of the bill and believe the provision should continue to apply to receivables acquired after August 4, 1983, notwithstanding our suggestion that the general effective date of the bill be deferred to transactions after December 31, 1984.

Again, Mr. Chairman, the Treasury Department strongly supports S. 1804, subject to the technical changes that I have mentioned. We look forward to working with you and members of the committee to effect these changes, thereby hopefully enabling early consideration of the bill by the committee. Thank you.

Senator DANFORTH. Thank you, Mr. Pearlman.

[Mr. Pearlman's prepared statement follows:]

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY (Tax Policy), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Committee: I am pleased to have the opportunity to present the views of the Treasury Department on S. 1804, which proposes to replace the current Domestic International Sales Corporation (DISC) provisions with a new system of taxing export sales income.

The Treasury Department strongly supports the enactment of S. 1804, subject only to certain technical changes that are necessary to preserve the basic revenue neutrality of the legislation.

After Ambassador Lighthizer's general description of the historical background and the need for a change in the DISC legislation, I would like to proceed with an outline of the tax provisions of the bill.

OUTLINE OF THE BILL

Overview

Under the present DISC provisions, the taxation of a portion of export income can be deferred on U.S. exports made through DISCs. S. 1804 is intended to preserve the competitiveness of U.S. exporters relative to their position under the DISC while, at the same time, being consistent with undertakings of the United States under the GATT.

The bill replaces the DISC, which is a U.S. corporation, with a Foreign Sales Corporation (FSC) through which export sales may be made. Provided it satisfies certain foreign presence requirements, a portion of a FSC's income will be excluded from U.S. tax at the corporate level. A 100 percent dividends received deduction will be allowed to domestic corporate shareholders of the FSC with respect to dividends from earnings attributable to the export sales income. By requiring certain export-related activities to be performed outside the United States, the proposal is consistent with the GATT understanding that income attributable to economic processes located outside the United States need not be subject to U.S. tax. These activities must be performed by the FSC, or on its behalf on a contract basis, outside the U.S. customs territory. Special rules, which I will describe later in my testimony, are provided to meet the needs of small business.

The current DISC provisions will be repealed except for those small DISCs, described later, whose shareholders elect to pay interest on tax deferred after the effective date of S. 1804. The accumulated tax-deferred income of all DISCs earned before the effective date of S. 1804 will be deemed previously taxed income and, therefore, will be exempt from tax.

Qualification of a FSC

A FSC must be organized under the laws of a jurisdiction outside the U.S. customs territory and must have at least one director who is not a U.S. resident. It must maintain an office outside the U.S. customs territory, and it must keep tax records both at that office and in the United States. In addition, it must elect to be treated as a FSC. The bill confers tax benefits only on income of the FSC (Foreign Trade Income) which is earned with respect to sales or leases of certain export property, or from certain export-related services.

Foreign economic process requirements

In order to obtain the tax benefits associated with Foreign Trade Income, a FSC must both be managed outside the United States during the taxable year and perform certain economic functions abroad in transactions producing the Foreign Trade Income. To be managed outside the United States, a FSC must have its shareholder meetings, board meetings, and principal bank account outside the United States. In addition, dividends and certain salaries and fees must be disbursed from foreign bank accounts.

For its export sales income to qualify as Foreign Trade Income, the FSC or its agent must participate in the solicitation, negotiation, or making of the contract relating to the export transaction outside the United States. In addition, 50 percent of the aggregate of the direct costs incurred in connection with the transaction by the FSC or its agent for

(1) advertising and sales promotion,
(2) the processing of customer orders and arranging for delivery,
(3) transportation,
(4) the determination and transmittal of a final invoice or statement of account and receipt of payment, and
(5) the assumption of credit risks

must be attributable to activities performed outside the United States. Alternatively, the FSC may satisfy the foreign economic process test if 85 percent of the direct costs in each of any two of the above categories is attributable to activities outside the United States.

Transfer pricing rules

The FSC can choose to determine its Foreign Trade Income either under normal Section 482 transfer pricing rules or it can choose to use the administrative transfer pricing rules specified in the bill. However, in order for export transactions between FSC's and related U.S. taxpayers to qualify for these administrative pricing rules, the FSC or its agent must perform all of the activities relating to solicitation (other than advertising), negotiation and making of the contract, and all of the five activities just described. Some of these activities can be performed in the United States. However, the 50-percent or 85-percent test under the foreign economic process rules must be met with respect to the expenses incurred for the five activities both by the FSC and its U.S. related parties.

The use of the administrative pricing rules, therefore, requires that significant economic functions be performed and, under the foreign presence rules, that the costs related to foreign activities account for a substantial share of the overall costs incurred. This is necessary to meet the GATT standard. The Administration is aware of the concerns of the business community that the foreign presence requirements will be difficult to meet without much added expense. As a result, the Treasury Department and the Office of the United States Trade Representative have worked with the business community to develop a detailed explanation of the foreign economic process requirements that goes as far as possible in alleviating business concerns while at the same time adhering to GATT understandings. This was transmitted to the Committee on February 1st.

Under the administrative pricing rules, the FSC may earn the greater of (a) 23 percent of the combined taxable income derived by it and its related supplier from the export transaction, or (b) 1.83 percent of the gross receipts from the transaction up to 46 percent of the combined taxable income from the transaction earned by the FSC and its related party.

Taxation of a FSC and its shareholders

The taxation of a FSC is designed to be comparable in result to a territorial system of taxation. The bill excludes a portion of the Foreign Trade Income of a FSC from U.S. gross income and therefore from U.S. tax. This exclusion reflects the significant foreign activities performed with respect to the transaction. If the transaction is subject to one of the administrative pricing rules, the excluded portion is 17/23 of the FSC's Foreign Trade Income. If, instead, the FSC chooses to apply the section 482 rules, or if its transactions are with unrelated parties, the excluded portion is 34 percent of its Foreign Trade Income. The remainder of the Foreign Trade Income is subject to U.S. tax. All investment income of a FSC also is subject to U.S. tax. Dividends from Foreign Trade Income of a FSC to domestic corporate shareholders are allowed a 100-percent dividends received deduction. The transfer pricing rules and partial tax exemption are intended to preserve the present pattern of DISC benefits for those exporters who can satisfy the foreign economic process requirements.

Small business provisions

The Administration recognizes the special problems that small exporters may have in establishing a foreign presence and satisfying the foreign economic process requirements. The bill therefore contains special provisions relating to small exporters. Under one option available to small exporters, a FSC that elects to apply the FSC pricing and tax exemption rules to no more than $2.5 million of gross export receipts in the taxable year need not meet the foreign management and foreign economic process requirements described above. The small FSC will therefore only have to meet the minimal foreign presence requirements such as foreign incorporation and the maintenance of a foreign office. In 1981, more than half of the active DISC's had less than $2.5 million in export sales. Because even strong export industries export on the average one-third or less of their output, it is probable that most firms with $2.5 million in export sales have total sales of $7.5 million or more. Thus, the $2.5 million threshold should enable a broad range of small firms to qualify for this option.

As an alternative, a small exporter can choose to retain its DISC and defer tax on income attributable to $10 million in gross export receipts, provided that the DISC pays interest to the Treasury on the tax liabilities deferred after the effective date of the bill. The interst rate charged will be the 52-week Treasury bill rate. In order to offset the interest charge, the bill increases the amount of tax deferred by eliminating almost all of the deemed distributions of the DISC to its shareholders. Because of this increase in the deferral rate and the opportunity to, in effect, borrow from the Treasury at very favorable rates, small exporters who elect this alternative will be about as well off as under the DISC.

There are other features of the FSC proposal which should make it easier for small exporters to adapt to the FSC. The elimination of the complex qualified export assets rules will greaty simplify paperwork compared to the DISC. Furthermore, small exporters may be able to reduce their costs by contracting out some of their foreign activities. For example, a firm that specializes in export sales abroad can perform the required foreign activities for a number of separate FSCs. The Administration is hopeful that this bill will encourage the growth of firms providing overseas export services to small exporters.

Use of tax havens

Under the bill, an FSC may be established in any jurisdiction outside of the U.S. customs territory, including the U.S. Virgin Islands, Guam, American Samoa and the Commonwealth of the Northern Marianas, but not including Puerto Rico. In addition, a certain amount of activity will be performed by the FSC outside the United States. It is unlikely that taxpayers will choose to organize and establish the operations of an FSC in those jurisdictions that have low or zero tax rates, i.e. in tax havens.

We do not believe that theestablishment of an FSC in a tax haven will increase the risk of abuse of the U.S. tax system for two reasons. First, to be eligible for FSC benefits an FSC must mainain detailed and complete books and records in the United States. Second, all investment income of FSC will be subject to U.S. tax. These measures protect against the two principal uses of a tax haven: to shield information from the United Sates and to earn passive income that is not subject to U.S. tax.

We have given further cosideration to the issue of tax haven use in context of the FSC. Notwithstanding tht protections have been built into the bill, it is a fact that auditing tax haven-base activity is extremely difficut without the full cooperation of the host country. Morover, several other countries have expressed dismay at the prospect that the FSC mght provide a windfall benefit to tax havens. This Administration also has consistently taken the position (for example, in the Caribbean Basin Initiative) that the Unted States should not provide a unilateral tax benefit to countries that do not cooerate fully in matters of tax administration and enforcement. The Treasury Deartment therefore is considering ways to ensure that the FSC proposal is consistet with our commitment to international cooperation in the exchange of tax informaion. We will work with the Committee and the exporting community in order to continue this commitment without unnecessarily undermining the effectiveness of the FSC.

Other suggested amendments

As I indicated at the outset, the Administration recommends that the bill be amended in certain respects because of further study we have made and comments we have received since its introduction. These suggested amendments are mainly designed to maintain the bill's revenue neutrality.

The first proposed amendment is necessary because of the delay in consideration of the bill. It is important that the general effective date of the bill be prospective. We recommend that the general effective date be changed from December 31, 1983, to December 31, 1984. Thus, transactions after December 31, 1984 would be eligible for FSC benefits.

The Treasury Department also recognizes that there are a number of transition problems in the bill that require attention. For example, export sales made through a DISC under a long-term contract may not qualify for exemption under the bill because the contract was made in circumstances that do not satisfy the foreign economic presence provisions of the bill. We would like to work with the Committee in resolving these traditional issues with the goal of maintaining the benefits that exporters anticipated in negotiating sales through DISCs.

The bill contains a provision extending FSC benefits to fungible agricultural products marketed through cooperatives. Agricultural producers would be able to obtain the FSC exemption on the portion of the cooperative's income attributable to exports. This benefit generally is not now available under the DISC because tracing of specific goods to ultimate export sales is required, and this is not generally feasible for fungible agricultural products. At the time this extension of FSC benefits to agricultural co-ops was first proposed, it appeared a relatively modest extension in terms of revenue cost. However, a closer review of its effect indicates that this provision would add about $100 million in revenue cost per year to the legislation. In addition, the provision appears inequitable because, in general, agricultural producers who do not market exportable products through cooperatives also cannot trace their specific output that is exported and, therefore, cannot enjoy FSC benefits. The Treasury, therefore, recommends that this provision be deleted because extending the prorating-of-fungible-products provision to all agricultural exports would result in an unacceptable increase of the revenue costs. Treasury will continue to consider whether the bill, as modified, will adversely affect the competitive relationship between cooperatives and other private exporters.

Further study also indicates that the interaction of section 28(a) of the Revised Organic Act of the Virgin Islands and the bill as introduced would cause certain unintended results. An FSC organized in the Virgin Islands would pay tax on its non-exempt income to the Virgin Islands instead of to the United States and could obtain a rebate of such taxes at the discretion of the Virgin Islands government. We recommend that the bill be amended to cause the non-exempt Foreign Trade Income and other income of an FSC organized in the Virgin Islands to be subject to U.S. tax. U.S. income taxes paid on this income would be made a creditable tax for purposes of applying the Virgin Islands mirror code. This proposed change does not in any way affect the eligibility of the Virgin Islands as a location for FSCs. It is required to prevent exporters from receiving larger benefits than intended and to preserve revenue neutrality.

Carrying charges and receivables

I would like also to give a fuller explanation of the need for the provisions of the bill relating to carrying charges and the purchase of receivables by a controlled foreign corporation (CFC).

Under present DISC rules, 95 percent of the accumulated tax-deferred income and other assets in the DISC must be invested in qualified export assets. DISCs also receive a deferral benefit on a portion of the qualified investment income on the export assets. Most of these qualified export assets are export receivables, in part because the DISC has an incentive to acquire the receivables from its parent, at a discount, and earn the return from holding them. If the parent continued to hold receivables from DISC sales, carrying charges or unstated interest would be split with the parent under the DISC rules. Thus, the amount of tax-deferred income would be reduced.

The FSC system in the bill provides for partial tax exemption of export income earned abroad, rather than (indefinite) deferral of tax, and U.S. corporate shareholders obtain a 100-percent dividends received deduction for FSC dividends from Foreign Trade Income. Qualified export asset requirements, which are very cumbersome under the DISC, are unnecessary under the FSC because there is no accumulated tax-deferred income. There are also no tax benefits for investment income under FSC, because, with no constraint on the kind of assets the FSC can hold, it would serve no policy purpose to give an investment income benefit to assets unrelated to exports. Consequently, the tax benefits in the bill are conferred exclusively on export sales and service income.

In designing a revenue-neutral bill, the exemption rate on export sales and service income was adjusted upward on the assumption that the investment income now received by DISC would be fully subject to U.S. tax. If the exemption rate on export sales and service income in the bill is retained, and the bill is to be revenue neutral, it is necessary to prevent FSCs from receiving investment income indirectly through carrying charges or unstated interest in a higher export price.

The bill therefore provides that FSCs will not receive any exemption on carrying charges including unstated interest. That is, for purposes of determining an FSC's Foreign Trade Income, the gross receipts from the sale will be computed as if the transaction were a cash sale. Rules imputing an interest component in export sales receipts, therefore, will have to be implemented.

The change from the DISC qualified export asset and investment income provisions to the FSC exemption approach also is the reason for the provisions of the bill related to trade receivables held by a controlled foreign corporation. The Treasury Department understands that some taxpayers take the position that a CFC, in certain circumstances, can acquire certain trade receivables, including export receivables, from a related corporation at a discount without incurring a current U.S. tax, either directly or under subpart F. Because an FSC, unlike a DISC, will no longer have a requirement or an incentive to hold export receivables, the large quantity of export receivables now held by DISCs would be available for possible acquisition by CFCs. If taxpayers could avoid U.S. tax on a portion of the large amount of export receivables now held by DISCs, the bill would no longer be revenue neutral.

The Treasury Department also believes that, in the context of subpart F, the financing of a related party's receivables should not be treated differently from a loan to the related party secured by the receivables. Therefore, the receivables provision was added to the bill both to preserve revenue neutrality and to address the larger tax avoidance problem.

The bill would cause income (including discount income) earned by a CFC from trade receivables acquired from related persons ("factoring income") to be subject to U.S. tax under subpart F. The bill also treats the purchase by a CFC of a trade receivable generated by a related U.S. person through the sale of inventory or the performance of services as an investment in "U.S. property." If such receivables held at the end of the CFC's taxable year constitute an increased investment in "U.S. property" over the prior year, there would be a pro rata inclusion in the income of U.S. shareholders of the CFC equal to the lesser of the amount of the increased investment or the CFC's earnings and profits. Although we recommend that the general effective date of the bill be changed to December 31, 1984, we nevertheless propose that this provision still apply to receivables acquired after August 4, 1983. The Treasury Department strongly supports these related party factoring provisions.

CONCLUSION

The Treasury Department strongly supports S. 1804, subject only to the technical changes I have suggested. The bill will enable U.S. exporters to preserve the competitiveness they have under DISC while at the same time complying with the commitments of the United States under the GATT. We hope that it will receive early consideration by this Committee.

Attachment.

REVENUE COST OF S. 1804 COMPARED TO DISC [1]

[In millions of dollars]

	Fiscal year—				
	1985	1986	1987	1988	1989
DISC cost	950	870	940	1,090	1,280
Total cost of export incentives after enactment of S. 1804	915	852	991	1,194	1,196
Additional cost of S. 1804	−35	−18	51	104	−84

[1] These revenue estimates assume (1) a 1/1/85 effective date and (2) the deletion of the provision in S. 1804 related to fungible agricultural products sold through a cooperative.

Note: Negative number represents a revenue pickup. 3 year cost: −$2 million, 5 year cost: $18 million.

Senator DANFORTH. Mr. O'Day.

STATEMENT OF PAUL O'DAY, DEPUTY ASSISTANT SECRETARY-DESIGNATE FOR FOREIGN COMMERCIAL OPERATIONS, DEPARTMENT OF COMMERCE, WASHINGTON, D.C.

Mr. O'DAY. Thank you, Mr. Chairman.

I thank you for the opportunity to present Commerce's testimony on the S. 1804 and add to USTR and Treasury's strong support for early action on passage of the measure.

I would like, with your permission, Mr. Chairman, to submit my statement for the record and just make a few brief comments on its content.

The statement covers the export environment at present that is the context for consideration of this legislation. Those facts, I believe, are well known to every member of the committee, and they don't bear repeating here except to note that exports could not be more important at the moment to the national well-being. I think that adds to the emphasis that the administration is placing on the importance of early consideration of this measure.

One of the most difficult challenges that we faced in drafting this bill has been touched upon by Mr. Pearlman, namely, incorporating within it measures that would assist small- and medium-size exporters to take advantage of the benefits under the legislation. The measures that Mr. Pearlman mentioned have been specially designed to assist small exporters in that regard. Our review of the facts indicates that the two main provisions designed for small exporters—namely, the ability to create a small foreign service corporation with a minimum foreign presence test and the ability to maintain a traditional DISC under much simplified rules, covering gross receipts up to $10 million a year—would cover approximately 85 percent of the DISC's now in place.

These are wide-ranging provisions that should be very useful across the small business community. In particular, from the Commerce perspective, Mr. Chairman, we think the combination of this legislation and the Export Trading Company Act that has been implemented in the past year by the Commerce Department and the Federal Reserve Board, will provide some creative opportunities for services to small businesses as they seek to use the benefits of this act.

S. 1804 contains provisions that allow for joint ownership of foreign sales corporations, and the regulations that will be put in place under the act would allow for joint ownership of offices abroad.

When that is combined with the authorities under the Export Trading Company Act on antitrust and on banking, we think there will be ample opportunity there for creative combinations of some of the strongest parts of our export community in the United States to put together the kinds of institutions that will be most useful to small- and middle-size businesses.

I appreciate the opportunity to testify and I look forward to any questions the committee may have.

Thank you.

Senator DANFORTH. Thank you very much.

[Mr. O'Day's prepared statement follows:]

Testimony of Paul T. O'Day, Deputy Assistant Secretary for Foreign Commercial Operations-Designate, U.S. & Foreign Commercial Service International Trade Administration, U.S. Department of Commerce

INTRODUCTION

Mr. Chairman, thank you for the opportunity to present this testimony on the views of the U.S. Department of Commerce on S. 1804, The Foreign Sales Corporation Act of 1983. This bill replaces the Domestic International Sales Corporation legislation which provides tax deferral benefits for exports.

The specific provisions of the proposed legislation are described in detail in the testimony and explanatory materials provided to the Committee by the Office of the United States Trade Representative (USTR) and the U.S. Department of the Treasury. I will limit my comments to the relevance of the proposed legislation to smaller firms and to the expansion of the U.S. export base.

BACKGROUND ON THE DISC

The DISC is the most well-known, and the most specific export aid used by U.S. firms. Its importance to exporters is reflected in the Treasury Department's data on the extent of its use by U.S. firms of all sizes. In 1973, the number of DISC returns to the IRS totaled less than 3,000—for 1981, this number had grown to 8,665, with much of the growth concentrated in recent years. From 1980 to 1983, the number of DISC elections increased by over 40 percent.

Now in its thirteenth year of operation, the DISC has been subjected to a continuing attack in the General Agreement on Tariffs and Trade (GATT) where a number of our trading partners have asserted that it is an illegal export subsidy. To resolve the matter, the Administration announced to the GATT in October, 1982 that the DISC would be replaced with a GATT-compatible alternative.

Since then, the Administration has been working with representatives of the U.S. export community to create a substitute that meets the following criteria:

—compliance with GATT rules,
—no greater revenue cost than the current DISC,
—benefits similar to the DISC for current users, and
—special provisions for the needs of smaller exporters.

The result is the proposed Foreign Sales Corporation Act now before this Committee.

S. 1804—GENERAL EFFECTS ON EXPORTS

S. 1804 has been designed as a substitute for the DISC, with comparable benefits to exporters, so recent experience under the DISC legislation can serve as a guide to the export effects to be expected under S. 1804.

The Treasury Department's most recent report on the DISC, covering returns for accounting periods ending between July 1, 1980 to June 30, 1981, shows gross receipts totaling $111.6 billion from exports of manufactured goods, with an associated net income of $9.1 billion. Treasury's analysis on the estimated reduction in exports if the DISC were eliminated for that period concludes that the dollar value of exports would have been down $7.2 to $11 billion.[1]

Within this overall effect, Treasury estimated that, without the DISC, exports would have decreased by the following amounts in four general sectors of the U.S. economy:

Decrease in dollar value of exports

[In billions of dollars]

Sector:	
Nonmanufactured products	$0.4 to 0.6
Basic manufactures	3.2 to 4.1
High technology manufactures	3.0 to 5.5
Resource related manufactures	.6 to .7
Total	7.2 to 11.0

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[1] 1981 Annual Report on the Operation and Effect of the Domestic International Sales Corporation Legislation, Department of the Treasury, July 1983. Table 3-1.

These export values are substantial, important contributions to the competitive position of firms across the entire range of U.S. manufacturing. The effects are especially significant in light of the importance of exports and international trade to the American economy. The growing relevance of trade to the American economy cannot be questioned:

—The ratio of U.S. merchandise trade—exports and imports—to U.S. GNP was almost 15 percent in 1982, up from about 8 percent as recently as 1970, and from less than 4 percent in 1960.

—Approximately 25,000 U.S. jobs result from each $1 billion in exports.

—One out of every eight American manufacturing jobs is related to exports.

—Exports now account for almost 5 million U.S. jobs.

—The product of two of every five acres of American cropland was exported in 1982.

The importance of trade to the national well-being, and the significant role of the DISC in the competitive position of so many industries, call for retention of similar levels of benefits as the form of the DISC is revised. The Foreign Sales Corporation Act before the Committee also has been carefully drafted to meet the necessary GATT requirements with minimum disruption to the existing business practices of U.S. exporters. As a result of the long and careful consultations with interested exporters led by USTR, the basic proposal in S. 1804 has wide support among U.S. firms engaged in international trade.

S. 1804 AND THE SMALL/MIDDLE SIZE EXPORTING FIRM

The basic requirement for benefits under the new system involves foreign presence and operations by the qualifying corporation. This responds to the central GATT principle that ties the legitimacy of the reduced tax burden to activities performed outside the boundaries of the taxing jurisdiction.

This foreign presence requirement can have a disproportionate effect on smaller exporters since the relative cost and inconvenience of the new system will rise as the size of the exporter declines. Smaller exporters may not be able to afford the expense of the foreign operations necessary to take advantage of the benefits available to a Foreign Sales Corporation under the general provisions of the Act. Accordingly, a number of special provisions have been included in S. 1804 to assure the availability of the Act's benefits to small or new exporters.

Small foreign sales corporations

S. 1804 contains a special category for Foreign Sales Corporations that elect to be designated as "Small FSCs," which then qualifies up to $2.5 million in annual export receipts for benefits under the Act. A small FSC need only incorporate abroad, or in U.S. possessions other than Puerto Rico, and maintain a minimum set of functions there to be eligible for Small FSC status (an offshore location and office, one non-U.S. resident director, and maintenance of books and records at the offshore office). Small FSCs will be exempt from the foreign management and foreign economic process requirements of the Act. This provision will ease the way into use of the FSC structure for new and small exporters.

The Treasury Department's most recent report on the DISC indicates that this option would have been available to over half of the DISCs in place in 1981.

Interest charge DISC's

S. 1804 allows small businesses which choose not to establish a Foreign Sales Corporation to maintain a DISC covering up to $10 million of annual export sales. These DISCs will pay an interest charge on accumulated tax deferrals occurring after the effective date of the Foreign Sales Corporation Act. Unlike the current DISC legislation which contains strict limits on the percentage of income eligible for tax deferral, S. 1804 generally would allow tax deferral on 100 percent of the DISC income earned on $10 million of export sales. The interest charges under this option will be levied at the 52-week Treasury bill rate, so the deferred funds will be available to the firm significantly below the cost of money in the open market. (These interest charges also will be tax deductible by the firm in the normal manner.)

This provision will allow smaller exporters to use the DISC form on a permanent basis if they find it to their advantage, or on a temporary basis as a transition to full use of the new Foreign Sales Corporation system. The "Interest Rate DISC" may be maintained until a decision is made to invest in either a "Small FSC," or in full FSC status.

Export trading companies and FSC's

Small businesses will also find that a combination of S. 1804 and the recently enacted Export Trading Company Act will provide a wide range of creative opportunities for enhanced export operations and benefits. S. 1804 allows joint ownership of a Foreign Sales Corporation, with up to 25 stockholders. In addition, the regulations anticipated under the Act will allow the joint use of offices abroad by FSCs. These and the other general provisions of S. 1804 should increase the range of services that can be provided by the export trading companies anticipated and encouraged by the Export Trading Company Act. This Act took effect in 1983 and is administered by the Department of Commerce (for antitrust clearance) and the Federal Reserve Board (for bank participation).

CONCLUSION

The special provisions for small firms included in S. 1804 will help to maintain benefits for this important sector under the Foreign Sales Corporation system. This is not just a matter of equity—small and medium size firms are an important source of new exports for the United States. In a U.S. manufacturing base of over 300,000 firms, only 1,000 account for over 60 percent of our exports. Increasingly, the U.S. international competitive position will be dependent upon effective and successful exporting in virtually every part of the manufacturing sector. Small and medium businesses have an important part to play in this process. S. 1804 contains a variety of tools and benefits that should aid small business with competitive products to enter and be successful in the international marketplace.

Much of the policy environment related to international trade is diffuse, contentious, and subject to wide variation in interpretation. From the viewpoint of the American exporter, the existence of the DISC since 1972 has been one of the few significant, tangible national incentives to expand their marketing activities across the globe. Enactment of S. 1804 will continue that incentive while we resolve a major irritant in our trade relationships. The U.S. Department of Commerce urges prompt action on this important legislative proposal.

FOLLOW-UP AFTER ENACTMENT OF S. 1804

Immediately upon enactment of the Foreign Sales Corporation Act, the U.S. Department of Commerce will undertake an intensive nationwide series of briefings and seminars to assure the widest possible understanding and use of its benefits for American exporters. This conference series will be conducted through the 47 domestic District Office of the U.S. & Foreign Commercial Service, in close cooperation with the 2,000 business advisors who serve on Commerce's District Export Councils.

Mr. Chairman, thank you for the opportunity to testify on this important subject. I would be pleased to answer any questions the Committee may have.

Senator **DANFORTH**. It is my understanding that the administration's position is that DISC has been very useful as far as U.S. business is concerned and that it has increased the level of exports which we otherwise would have had without DISC.

In the booklet that the joint committee put out, it states at the beginning that the estimates are that in 1981 DISC accounted for about $7 to $11 billion worth of exports which otherwise would not have occurred. So, am I correct in understanding that the administration feels that DISC has been a very useful tool of American business in exporting?

Mr. **LIGHTHIZER**. Yes, that is correct, Mr. Chairman.

Senator **DANFORTH**. If we were to do nothing, the result of doing nothing would be that duties would be imposed against various U.S. exports in order to counter the subsidy which DISC provides?

Mr. **LIGHTHIZER**. That is our fear, Mr. Chairman. That our trading partners will take action to counteract what they consider to be an illegal subsidy.

Senator **DANFORTH**. Do you think you have a good basis for that fear? Have they indicated that to you?

Mr. LIGHTHIZER. Yes, they have, Mr. Chairman. This has been a dispute, as you know well, that has been going on for a number of years; and it has heated up from time to time, most recently in 1982. The European Community came very close to retaliating in 1982 and our sense is that they are close to doing that again at this time.

And indeed, the reason that they didn't in 1982 was that we agreed to try to come up with a piece of legislation that was consistent with the GATT and that would be acceptable to the Congress. S. 1804 is the result of that effort.

If this effort is stopped, we believe the EC would go back on track toward retaliation.

Senator DANFORTH. They began challenging DISC as soon as it was enacted into law. Is that correct?

Mr. LIGHTHIZER. That's correct, Mr. Chairman.

Senator DANFORTH. So, the European Community's proceedings against DISC have been going on now for about a dozen years or so?

Mr. LIGHTHIZER. That is correct. They became concerned in 1971.

Senator DANFORTH. And they have formally made their complaint against DISC, before GATT, and they feel that now they are in a position to retaliate at long last? Is that correct?

Mr. LIGHTHIZER. Yes, sir. In 1976, they got a GATT panel decision, and it was consistent with their position. And since that time, they have been considering retaliations, certainly after the time that the GATT panel decision was adopted by the Council. They have been very much inclined to retaliate.

Senator DANFORTH. But retaliation under GATT isn't something that just happens instantly. In other words, this is a long process of objecting and bringing the matter before a GATT panel, and after years of study and analysis, DISC has been considered by them to be an illegal subsidy which would give rise to countervailing duties. It is not something that is a summary kind of proceeding.

Mr. LIGHTHIZER. No, sir. Indeed, I am sure that from the Community's point of view and that of some of our other trading partners, the process has even been a little lengthy already.

Senator DANFORTH. Now, has the idea of the FSC been run by the European Community? Do we have any view of what their reaction is to it?

Mr. LIGHTHIZER. Yes, sir, Mr. Chairman. We have described this approach to a number of our trading partners and particularly the Community, since they were one of the key problems in the past.

We don't, at this time, have a clear idea of what their final view is. They clearly—they have indicated in informal communications that they are troubled by a number of the aspects of the proposed legislation. We don't consider ourselves to have a final negative response from them, however, and indeed, Ambassador Brock is talking to his counterpart about this and other matters right now.

Senator DANFORTH. How about the rest of our trading partners?

Mr. LIGHTHIZER. We have invited our trading partners to come in and give us their opinion on this proposal. We have gotten some response from the Canadians and from the Brazilians, which has not been a negative response at this time. They also are troubled by some matters, but are less negative than the Community is.

Senator **Danforth**. Let's suppose we were to enact this new program, and there were trading partners which didn't like it and considered it to be an illegal subsidy. DISC took 12 or 13 years to adjudicate. Wouldn't the process start all over again?

I mean, not that we are just trying to set up procedural hurdles for people, but it would certainly not be clear on its face that this FSC idea is contrary to GATT.

Mr. **Lighthizer**. It certainly is not clear on its face that it is contrary to GATT. Indeed, our view is that this proposal is consistent with the GATT, and we would be in a position, I believe, if it is enacted, to make that argument very strongly.

Senator **Danforth**. In other words, Congress does not have to have absolute certainty that it wouldn't be challenged in order to justify passing the bill. The fact is that whether or not it is challenged, we feel that we have a very good argument, and that even if it were found to be GATT illegal, it would certainly not be an instantaneous process.

Mr. **Lighthizer**. That is exactly right, Mr. Chairman. Indeed, I would not want in any way to mislead the committee into thinking that this would not be challenged. It may very well be that one of our trading partners would challenge it. But our view is that it is consistent with the GATT.

Senator **Danforth**. Mr. O'Day, you talked about creative possibilities for smaller businesses and joint ownership of these foreign operations and the possible use of the export trading companies.

I know that in connection with export trading company legislation the Commerce Department was to go out into the country and explain what export trading companies are all about and work with small businesses, particularly, to help them understand the concept and put them together.

What would be the position of the Commerce Department in working with small businesses to try to realize what these creative possibilities are?

Mr. **O'Day**. In the case of the export trading company legislation, Mr. Chairman, we put on a series of nationwide conferences that had a total attendance of more than 10,000 people. We would expect that, with the passage of this legislation, we would hold the same kind of nationwide series of conferences. The attendance in that instance should be much higher because we would draw not only people who are interested in creating export trading companies, but we would tend to draw the small- and medium-size businesses who would want to know the full range of possibilities under the act.

We have a total of 47 district offices around the country, and an additional 21 satellite offices, and 2,000 private sector members in our district export councils, all of whom would be intimately involved in putting together as quickly as possible a full range of conferences and briefing sessions on the new act.

We are ready to do that the moment the act passes and start to get the word out so that we begin to expand the export base with as many small- and medium-size companies as possible.

Senator **Danforth**. Let's suppose somebody had a middle-size company, the company had been involved in exports and had used DISC, and it wanted to continue to use the new program but was sort of baffled by the new requirements about the conduct of certain sales activities abroad. And they say: We don't have anybody abroad, we don't have any office abroad right now. We don't have anybody who speaks the language of the people we are trying to deal with. We don't think we can do it. Are you fairly confident that people who would have that initial reaction could, in fact, find out how to get it done in a reasonably accessible way—setting up sales operations and so on abroad?

Mr. O'DAY. We think so. One of the main options here would be for them to maintain their current DISC, and as I mentioned, about 85 percent of the DISC's fall within the guidelines of $10 million or less in foreign sales receipts. They could maintain their current DISC under much simplified rules and pay an interest charge on the tax deferred. That interest charge would be pegged at the 52-week Treasury bill rate, which is about 9 percent at the moment. There are no other complications involved. You don't have to get involved with bankers or any complicated forms. They just carry this out on their tax returns, and they, in effect, are getting a loan of that money at some 4 to 5 points below the open market.

So, that is a fairly substantial benefit that would allow smaller companies to ease into full consideration of the use of the entire foreign sales corporation structure.

Following that, I think a small company could then take a hard look at whether it would want to elect to be a small foreign sales corporation under the provisions of the act, which has a very minimum presence abroad requirement. It is there that we think that the export trading company structure—which is now growing substantially under the act that was passed and implemented last year—would be a good vehicle for joint cooperative relationships to get those kinds of mechanisms in place.

Senator DANFORTH. Just one final question for Mr. Lighthizer. I suppose one thing that we could do would be to go to the EC and say: Look, here is our statute, and do you have any complaints with it? If so, tell us what the complaints are, and we will try to fix that and build it into the law. My guess is that it would not be a very fruitful way of proceeding.

That is to say, we now have, a variety of trade problems with the EC, and my guess is that they would be pretty darned hard to satisfy. Would you agree with me that it is not necessary to have absolute assurances from the EC that they are totally satisfied, that we should proceed with our best effort without attempting to cross every "t" and dot every "i".

Mr. LIGHTHIZER. Absolutely. I agree completely with that position, Mr. Chairman. We have, in fact, gone to the Community. We have tried to explain the provision, and we will continue to do that. We would like to have their agreement that it is consistent with the GATT, but I think that we have to do what we think is consistent with our international obligations, regardless of what the Community decides. So, I agree with you.

Senator DANFORTH. Senator Heinz?

Senator HEINZ. Mr. Chairman. Thank you.

I have a number of concerns about the legislation which I think are addressable. We have talked about the treatment of small business under DISC, and I want to give that question more study. We will get some illuminating testimony from some of our other panels on that.

I have had some discussions with USTR about the status of coal—coal exporters—that may require looking at the studies and some of the comments we receive today—possibly some adjustment.

But I want to return to the question raised by the chairman regarding how this fits with the GATT complaint. I know that Bob Lighthizer is accurate when he says that a GATT panel first found against this back in the mid-1970's—1976—but I also seem to recollect that there was a lot going on in that period that we should understand might have resulted in a purposeful slowing down of the extent to which EC was willing to proceed with retaliation against us.

For example, the Tokyo Round was very much in full swing in 1977 and 1978. Indeed, we concluded negotiations, wrote a trade act—enacted it in 1979—and not withstanding some testimony this committee received, Mr. Lighthizer will remember—that, my goodness, we never even—we refused to discuss giving up DISC. Mr. Strauss and others said there is—what I will call politely—at least circumstantial evidence that those discussions went far beyond the way they were represented to the Finance Committee.

And for a number of years, the Carter administration went back and forth as it was trying to satisfy some kind of commitment that it had made to the EC to work out the DISC problem. And here we are—after a new administration and another year or two of trying—with the FSC proposal.

So, it seems to me it is not necessarily so that it is going to take—if we change the law—another 7 or 8 years for the EC to decide to retaliate. Let me ask Mr. Lighthizer. If the European Community were really offended, let's say by the forgiveness of taxes, which is part of the administration's FSC proposal, how quickly could they proceed?

A. Through the GATT? B. By the application of simple countervailing duty statutes?

Mr. LIGHTHIZER. Well, B is easier to respond to, Senator, because they could, in fact, do whatever they want to, inconsistent with the GATT. So, they could retaliate against us as quickly as they could bear some piece of paper that said——

Senator HEINZ. So, we could change the law and be retaliated against within a matter of months.

Mr. LIGHTHIZER. If they decided to act outside of the confines of the GATT. That is correct.

Senator HEINZ. Which is quite legal, is it not?

Mr. LIGHTHIZER. It would be legal within their own legal system, presumably.

Senator HEINZ. And consistent with the GATT subsidies code? No?

Mr. LIGHTHIZER. No; our view is that they would have to get authorization from the GATT Council to retaliate against us.

Senator HEINZ. The way that would work is they would go—you are saying that if a country thought that one of our companies or industry which had received a lot of tax forgiveness from us and therefore ended up, in effect, with a lot more cash—they wouldn't have to act on an individual Government level—they would have to go to a GATT Council?

Mr. Lighthizer. Yes; they would have to——

Senator Heinz. Is that only an EC responsibility?

Mr. Lighthizer. No; I am saying it is a GATT responsibility. They would have to get permission from the GATT to retaliate against us if they were going to do it consistent with the GATT.

Senator Heinz. When we retaliate against subsidies, do we do that? Under our countervailing duty statute?

Mr. Lighthizer. They could go through their own legal system and have an injury determination and countervail, and that is consistent with the GATT.

Senator Heinz. That is what I am asking. They could do that independently, without going to the GATT.

Mr. Lighthizer. That is correct.

Senator Heinz. They could do it fairly rapidly.

Mr. Lighthizer. That is correct.

Senator Heinz. Our process can take up to a year or so but their process doesn't have to take up to a year. They are not as legalistic as we are.

Mr. Lighthizer. That is correct.

Senator Heinz. It is hard to imagine anybody who would be more legalistic than we are. And finally, they could do all of the above—that we have just described—and be consistent with the GATT, provided there was a finding of injury.

Mr. Lighthizer. That is correct.

Senator Heinz. All right. That was the first point I wanted to make. Now, you are saying there is another way they can go—they don't have to find injury; all they have to do is go to a council, and the council says this is or isn't a subsidy. I understand that the GATT is maintaining this is a subsidy right now.

Mr. Lighthizer. That is correct. The GATT maintains that the DISC is an illegal subsidy.

Senator Heinz. Is my understanding incorrect that the European Community has raised as one of its principal objections that the forgiveness of taxes on deferred DISC income is a massive new subsidy for which the United States must pay compensation to EC? Is that or is that not their position?

Mr. Lighthizer. That, we believe, is their position.

Senator Heinz. And then, I suppose, there is the other mechanism available which is, as the chairman suggested, one of three alternatives—they could really kind of start all over again, and take FSC per se as a program with all the other objectionable elements that, we think, they object to—to a GATT panel and ask GATT to find the entire process or several elements of the entire process you propose to be inconsistent with the GATT. So, they have got three bites at the apple—some faster, some slower.

Is that right?

Mr. Lighthizer. That is correct.

Senator Heinz. Mr. Chairman, I am as concerned as you are about how we deal with the DISC. It is not immediately apparent to me that the best strategy—if indeed we are likely to run into prompt retaliation if we enact this proposal—is simply to go ahead and act on it. It would seem to me that that would just substitute one kind of trouble for another kind of trouble.

But that is an impression. I don't wish you to think—the members of the committee—it is my final impression, but it is a great concern, and I thank you.

Senator DANFORTH. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Pearlman, you believe that DISC's are worthwhile?

Mr. PEARLMAN. Yes. Our study shows, Senator Chafee, that DISC's have had a positive effect on exports, not only in terms of absolute dollar amounts as the chairman indicated earlier, that is, that it has increased exports in the range of $7 to $11 billion, but in addition to that, in terms of merchandise exports that 2 or 3 percent—in that range—of all exporting is done—there has been an increase of 2 to 3 percent, so there has been a net gain.

Senator CHAFEE. So, that has been the net gain. Therefore, what is the philosophy of restricting the proposal to no change in revenue?

Mr. PEARLMAN. I think that our philosophy generally has been, Senator, not only with respect to the FSC legislation, that we have been very reluctant to come forward with any proposal that has an adverse revenue impact, and I think that——

Senator CHAFEE. Obviously, you think things are worthwhile because you think that you produce more revenue even though you show a net revenue loss. Obviously, by supporting DISC, in manufactured goods, you think it produces more revenue for the country overall. You don't even have to say in the long run—even in the short run. Isn't that so?

Mr. PEARLMAN. Yes, I think that is true, but when we bring a legislative proposal to the Congress, we look at the immediate revenue impact in an environment of very substantial deficits and concerns about the size of the deficit. We are very concerned that the FSC bill be as revenue neutral as is reasonably possible.

Senator CHAFEE. I don't argue with that, but I am concerned about services. We are really in an intensely competitive situation in the world in which we have managed through skill and good fortune to maintain our lead in services. The growth in exports is in the service sector. Until a few years ago when our balance of trade got out of hand, it was the service sector that provided us with that margin that made our exports and imports about neutral.

Now, I have looked over the testimony of Mr. Howard, who will be testifying on behalf of the American Electronic Association, and also the testimony of the gentleman from Digital. These gentlemen point out how important exports are and not just because of the increased dollars, but because those increased dollars give them the revenue so that they can proceed with their R&D and thus maintain the computer edge of the United States.

It seems to me that we are making a great mistake not to include services in FSC. If you believe in the philosophy of DISC or FSC, then obviously you must believe that you would get even more jobs out of it if you included services and thus you would get more total revenue. Therefore, to exclude the burgeoning section of exports with the greatest potential of all—services—seems to me to be a great mistake.

What is your answer to that?

Mr. Pearlman. Senator, there are a number of proposals before this committee that we think will have collateral positive effects, but we do have to be sensitive to the revenue impact of tax legislation. If you were to add services to the FSC, which would be a dramatic departure from what is presently encompassed within a DISC, you would have a dramatic revenue impact on the bill.

I think that is the key issue with respect to services.

Senator Chafee. You might also have a dramatic gain in jobs and the increase in revenues that come with it. What worries me is that we are liable to lose our edge here. If you look over the testimony of Mr. Howard—and, of course, one of the problems with these hearings is that we always get the administration people on first and then you hustle back to your offices and then we hear the other arguments—but the administration is long gone, so we have no chance to ask what do you say to that? But I did look ahead, and now I do say to you: What do you say to that?

Other countries are already addressing questions relating to the tax and legal treatment of software, and in doing so, are positioning their companies to obtain a large and growing share of the software market. This is on page 7 of Mr Howard's testimony.

I think you must share the deep concern that I have that there is one area in which we are ahead. We are not ahead in steel, and we are losing in automobiles and a host of other areas.

Here is one area in which we are ahead—services generally, and certainly in software specifically. I think we ought to do everything we can to maintain that, and if the revenue losses are too traumatic in 1 year, can't there be some kind of a phasing in? Can't we hold out hope for these people?

Mr. Pearlman. Senator, I thought it was not cricket for people to read testimony in advance, so you really have caught me. [Laughter.]

Mr. Pearlman. We are not very far away, and I think——

Senator Chafee. I spend night after night in advance reading your testimony. [Laughter.]

Mr. Pearlman. I am not going to question your judgment. [Laughter.]

Mr. Pearlman. We would like to take a look at the submissions and we will be happy to try to follow up and give you our thoughts after we have had the opportunity to do that.

Senator Chafee. What do you say to all this, Mr. Lighthizer?

Mr. Lighthizer. Obviously, we are concerned at USTR about the revenue impact of expanding FSC treatment to services. Our mandate from the President through the Cabinet Council on Commerce and Trade was to come up with a GATT consistent proposal that would have the same effect on the exporters and that does not increase the revenue outlays.

Senator Chafee. What do you say, Mr. O'Day?

Mr. O'Day. Senator, I think that my first reaction to that is that it is an extraordinarily complex area because services is a basket of two dozen or more widely different industries from tourism to leasing to software—as you mentioned—and so on and so on.

I think that any analysis of that would differ widely amongst those sectors, so I would not want to venture an across-the-board response to that. I think it bears a great deal of study before a conclusion is made as to where the most effective extensions of a piece of legislation like this would be effective—what areas it would be most effective in.

Senator CHAFEE. Let me ask Mr. Pearlman one more question. What is the legal significance of the recently issued explanation by the administration of the principal provisions of the FSC program? Would you expect that the explanation would be reflected in the regulations if the FSC proposal is enacted?

Mr. PEARLMAN. Yes. I think I would have to qualify that in general, but this was our best preliminary analysis of the proposed legislation. It was designed to try to identify the way we believe the statute will operate. While obviously we have to reserve the right for more careful reflection, it would be our intention to reflect this explanation in administrative interpretations of the statute after it is enacted. We would hope that if people—either members of the committee staff or others—disagree with what our views as to the statute are, they will bring them to our attention and that that process will be constructive, both in bringing the statute to a final vehicle for enactment and will also help us in putting out administrative pronouncement following enactment of the statute.

Senator CHAFEE. A final question to Mr. Lighthizer. You heard the explanation of Mr. O'Day. What do you think about services? I know that you are bound here when you testify to support the revenue neutral provision, but let's set that aside, and just take the ability to deal with services as an export factor and look toward their inclusion somehow in DISC or FSC.

Are there extraordinary complications or can this thing be worked out?

Mr. LIGHTHIZER. I am sure it can be worked out. With respect to specific services, it may also be beneficial. But there are some where inclusion in an FSC would probably be very helpful. But our position now is that for revenue reasons, we don't support that provision.

Senator CHAFEE. Thank you. Thank you, Mr. Chairman.

Senator DANFORTH. Is this FSC proposal similar to what other countries are doing? Does it have any counterparts in the rest of the world?

Mr. LIGHTHIZER. There are none that we are aware of. Our view is that it is a way to compensate for the inherent advantages in the territorial tax system which most of our trading partners have.

Senator DANFORTH. Meaning what? That their present tax systems give them an inherent advantage and this is not an effort to copy them but at least provides some offsetting advantage?

Mr. LIGHTHIZER. I think that is correct. We have a global system of taxation with special treatment for export income under DISC which has been found GATT illegal. Many of our trading partners have a territorial system of taxation which exempts export income from taxation. Since we are repealing DISC for GATT reasons, we are replacing it with a territorial treatment of export income because it has been found GATT consistent.

Senator DANFORTH. Our territorial system is equally of benefit to manufacturing companies and to service companies, isn't it?

Mr. Lighthizer. I would presume so, Senator. I just can't answer that. I would presume so.

Senator Danforth. It wouldn't be any different as far as they are concerned?

Mr. Lighthizer. That is correct, Mr. Chairman.

It may be different in terms of services rendered outside of a country. There may be a difference in terms of the site of the services. I simply can't answer.

Senator Danforth. We are not going to be in session all that many days in 1984, and some people think that our legislative agenda is going to be a little bit thin. Is it crucial that we pass this this year, or can we wait?

Mr. Lighthizer. We feel very strongly, Mr. Chairman, that it should be passed this year. I mean, whether it is crucial or not depends on the patience of our trading partners.

Senator Danforth. Would the administration take the position that it would urge the majority leader to take this bill up and that it would consider it to be one of the items which really should be a part of the legislative agenda this year?

Mr. Lighthizer. We clearly feel that it should be part of the legislative agenda. Now, I don't want to comment how it ranks versus other pieces of legislation. Obviously, there are some that even in the Treasury——

Senator Danforth. It is not up there with the reciprocity bill.

Mr. Lighthizer. No, it is clearly not in that league. [Laughter.] But it is still very important.

Senator, if I could, I would like to comment again in response to Senator Heinz' question, and that is that while the community can do a number of things—they can countervail, although they never have, against DISC or against the FSC, for that matter—they could act outside of the GATT—they could ask to get council to authorize retaliation—or they could file a whole new case. The fact is that we have obligations to all of our trading partners to try to behave in a way that is consistent with the GATT. And it is our view that this does that, regardless of what the Community does.

Senator Danforth. OK. Senator Boren is here now. Also, I think some of the members of the committee might have questions that they would want to submit in writing, so we will keep the record open if you would be willing to answer them in writing.

Senator Boren.

Senator Boren. Thank you, Mr. Chairman. I would like to enter an opening statement for the record in full but I will summarize.

I think we are dealing with a tremendously important subject when we consider that exports attributable to DISC have grown from 1.9 billion in 1972 to 11 billion in 1981.

And as you know, Mr. Chairman, I was a sponsor of a predecessor proposal to the Foreign Sales Corp. proposal. I worked with the administration as well as with a broad range of industry groups to insure that this essential incentive is preserved. There are several elements of this FSC proposal which are before us which I think are very essential to its effectiveness including the forgiving of tax on DISC income that has already benefited from tax deferral. I think this is a provision that must be kept intact, and several others.

Primarily, I believe that we must guarantee that the incentives provided that the FSC proposal are at least equal to those of present law. They must serve as an incentive to all of our exporters who have used DISC in the past. Small exporters have used DISC and should be accommodated in this proposal so that they can continue to have access to the same export incentives available to large exporters. That is a matter of very great concern to me.

The foreign presence requirements in the FSC proposal could prevent many smaller firms which have taken advantage of DISC from utilizing the FSC benefits. The small business provisions in the bill reflect a sensitivity to this problem. The $2.5 million exemption serves as a good first step toward assisting these firms, but I intend as we go along to introduce amendments to modify this proposal in such a way that they will make small business compliance with FSC rules less cumbersome and thereby permit our small exporters to benefit as they have under DISC.

Considering the deterioration of America's balance of trade, we simply cannot afford to delay our efforts to strengthen this essential export promotion tool. I hope that we will be able to move very quickly on this FSC proposal. It has my strong support. I simply hope that we can strengthen it in the area of assisting small businesses.

I would like to ask a few general questions along that line, and address them to any members of the panel.

First, do you think that many of the firms that currently use DISC will not be able to comply with the foreign presence test in the FSC and may terminate their export operations completely? Do you think that it is in our best interests to penalize these small exporters as this bill currently drafted would do? Following up on that, considering the fact that the DISC annual report shows that about 8 percent of all gross receipts were under $10 million, do you believe that expansion of the exemption to $5 million or possibly to $10 million from the present $2.5 could be considered to have de minimus impact for GATT consideration?

Mr. LIGHTHIZER. Let me try to answer the tax piece. There may also be a GATT piece to your question, Senator. Our data indicates that 50 percent of the DISC's involve sales of less than $2.5 million. So, while it is true that there are a number of firms with sales in excess of $2.5 million are going to have to meet the requirements of the statute, the $2.5 million threshold encompasses a very substantial number of organizations presently formed as DISC's.

My own feeling is that there will be a support system that develops to provide those services to FSC. Indeed, we have heard of organizations that are interested in providing the foreign services to FSC's as agents, which is quite appropriate and proper under the bill. I would guess that such a support system will develop and the services will be made available to exporters who can't meet the $2.5 million test or choose not to, but who do want to take advantage of FSC.

Senator BOREN. I just looked at the CRS analysis of the impact of changing from the current method under DISC for small businesses to the FSC proposal. It was my understanding that our goal in the beginning was to come up with a GATT legal proposal but one that would maintain approximately the same level of tax benefits and incentive which we now have. Some of us would love to see the incentives increased—but realizing budgetary constraints, we were attempting to come out about where we are now. I notice the CRS analysis says that the tax benefits that most large exporters would receive would approximate the size of their current tax savings under DISC.

However, in general, smaller exporters would receive a smaller tax savings under the FSC provisions than they are currently receiving under the DISC. Moving into export markets by any of our smaller business concerns really seems to be an area in which we could perhaps have the greatest amount of growth and in our presence in world markets.

Don't you think it is imperative that we try to do everything that we can to facilitate that participation by small businesses?

Mr. Lighthizer. I would just add that, yes, we think it is very important to facilitate small business use of FSC. That is one of the points described in detail in our general explanation.

We are prepared to continue to look at the FSC as it relates to small business with the revenue constraints and whatever GATT constraints must be taken into consideration.

Senator Boren. Do you have any analysis that would differ with the CRS analysis that this proposal now as drawn provides a slightly less incentive to small exporters than does the present DISC proposal? Or do you pretty much accept the CRS analysis?

Mr. Lighthizer. Senator, I would prefer—since I am not prepared to respond to your question now—to provide a response to that.

Senator Boren. That would be fine. There are several things that have been talked about as possible ways of perhaps improving the situation as far as small business is concerned.

What about the proposal to change the test from a $5 million gross receipts to $5 million in gross income? That is one proposal that has been made. How would you view a proposal like that?

Mr. Lighthizer. Our position, Senator, is that $5 million threshold would not be a de minimus exception. At least to some extent it is a judgment call. The larger the group we exempt from the foreign economic presence provisions, the more likely we will face a successful challenge to this new proposal in the GATT. That is the reason that we picked $2½ million which is somewhat arbitrary, but nonetheless reasonable to our trading partners.

Senator Boren. What about allowing small exporters to have some presence in U.S. foreign trade zones? This is another proposal that has been made—to allow small exporters to have additional presence or some presence in U.S. foreign trade zones rather than abroad to satisfy part of the foreign presence requirement. If you were dealing with small businesses, would that be something that you might examine or look at as a possibility, as an alternative?

Mr. Lighthizer. Our view, Senator, is that we are trying to set up a scheme which does not tax economic processes outside the United States and that a foreign trade zone that is within the United States would not be consistent with that design.

Senator Boren. Let me try a couple of others on you. Could firms that export primary agricultural products, which are not profitabed from receiving subsidies under GATT, continue to use the existing DISC?

Would that be a possibility? If you have a situation where you have exporters who are not prohibited from receiving subsidies under GATT?

Mr. Lighthizer. I am sorry, Senator. The question was whether or not somebody who was exporting agricultural products under the DISC——

Senator Boren. Primary agricultural products.

Mr. Lighthizer. Primary agricultural products could continue to——

Senator Boren. Could they still use DISC if it were more favorable for them?

Mr. Lighthizer. They could not under this provision. But your question is whether it is GATT consistent; and if they did not substantially increase their market share, then it probably would be consistent with the GATT.

Senator Boren. Perhaps that is something that could be explored in terms of making a provision in this bill for it.

Mr. Lighthizer. That is something we will look at.

Senator Boren. There are some that have argued to me that agricultural cooperatives might benefit at the expense of other agricultural concerns under this proposal. Have you examined that aspect of the proposal?

Mr. Lighthizer. Yes, we have, Senator, and as we indicated in our written statement, we propose to delete the provision in the bill dealing with agricultural cooperatives for two reasons. One was the revenue impact, and second was the discrimination between agricultural products marketed through cooperatives versus agricultural products otherwise sold abroad.

Senator Boren. I think we still have a problem. I am a little disappointed that you have not reacted more enthusiastically to some of the possible alternatives that we might examine.

I would hope that you would look at that again more carefully in terms both of agricultural products in particular that are able to follow certain procedures and also perhaps expanding the size of the exemption or looking at some of these other options, or maybe a combination of options. Let me ask this: If we do decide, through the legislative process, to make some changes—and again, I am not talking about going overboard—I am talking about such things as changing the gross sales to gross income or some other option like that. Would the Office of USTR with the support of the rest of the administration be willing to take this proposal—the FSC proposal—if we did decide to make some relatively constrained small business modifications, and take it to the GATT council and argue for its acceptance, would you defend it if this were the result of the legislative process?

Mr. Lighthizer. The answer to that question is yes, argument would obviously be affected by the nature of the changes, but if Congress makes changes in this proposal, whatever the changes are, we will go and forcefully defend them before the GATT Council.

Senator Boren. Mr. Chairman, I won't take more time. I appreciate your indulgence already, but again, I do hope that you might take a second look at that area, and I do want to serve notice that I will be offering some amendments in the small business area and hope that I can work with the administration on them. We certainly will try to offer those that would have the greatest chance of passing GATT tests. And I hope you will be willing to sit down with us and perhaps take a second look at that area.

Otherwise, I certainly am a strong supporter, of course, as you know of the concept we are dealing with here in this bill.

Senator Danforth. Senator Grassley.

Senator Grassley. I have no questions of this panel.

Senator Danforth. Senator Dole.

[No response.]

Senator Danforth. Thank you very much.

Mr. Lighthizer. Thank you, Mr. Chairman.

Senator Danforth. Congressman Frenzel.

STATEMENT OF HON. BILL FRENZEL, U.S. REPRESENTATIVE, STATE OF MINNESOTA

Mr. Frenzel. Mr. Chairman, I do have a statement I want to insert.

Mr. Chairman, I am joined by my associate, David Rosenhauer. I would request permission that my statement be included in the record and that I might proceed to summarize the statement.

Mr. Chairman, I appear in favor of the administration's DISC bill. I do not believe that it is perfect, but I believe that insofar as we can perceive at this time it will withstand the GATT tests.

We have, as your committee knows, been under attack in the GATT. We have been through the grievance procedures. We have lost, and we have promised to replace the DISC with something else, or at least to get rid of the DISC.

We are overdue, and I am delighted that your subcommittee has proceeded with these hearings. I have been less fortunate—or less successful—in persuading my own chairman to begin work on this problem. We have a commitment. We ought to follow it up. We are shortly going to probably be the victims of retaliation if we don't proceed ourselves.

One of your committee members, Senator Boren, has done an extraordinary amount of work on this particular problem, and I want to congratulate him for what he has done. Again, I have probably some similar ideas of how the bill might be approved, and I want to simply list four of them for your consideration.

There are obviously other ones. The first is that the current DISC law benefits also go to individuals as well as to corporations. The FSC proposal does not. And that means that an unincorporated business would not get FSC benefits. I suspect that there are very few small unincorporated people who would like to take advantage of the benefits, but if there are, they ought to have a chance. I doubt there would be any significant cost attached to that.

The proposal also gives FSC benefits to farm cooperatives and in so doing creates a distinction between those who market their products through coops and those who do it in other ways. I think that is going to be a problem because it is going to give agricultural producers who sell their products to tax exempt coops the full FSC benefits while farmers who sell their products to other purchasers in the distribution chain are going to receive no FSC benefit.

I think that something has to be done with this discriminatory feature, and I leave it to your great good judgment whether you expand it to everyone or give it to no one.

I think it is terribly important that computer software be eligible for FSC treatment. I believe that that is one of the great U.S. offshore markets. I think it ought to be stimulated, particularly for the young and growing companies that are developing software, and I think it is a major deficiency in the bill that we have not made it clear that computer software is eligible.

You will note in the bill that there are additional items that weren't in the DISC bill, including coal. I think coal needs DISC or FSC treatment, and I hope that you will want to keep them in.

The final problem relates to services. My personal belief is that service industries should be included, with perhaps the only restriction that the services be produced or generated within the United States.

Again, you know the statistics—what service trade the U.S. indulges in—and I believe that, for instance, if a U.S. advertising company which creates an advertising concept does the work in this country, and then attempts to merchandise them abroad, it ought to be able to get FSC benefits from spreading its concept and its campaigns abroad.

I think that S. 1804 is a good vehicle to begin work. Like Senator Boren, I think there are other changes that I have not discussed. The four that I have presented to you are important ones. I hope you move along, and I congratulate you for getting it.

Senator DANFORTH. Thank you, Congressman Frenzel, for your very helpful testimony, and we will consider all of your comments.

[The prepared statement of Congressman Bill Frenzel follows:]

STATEMENT OF THE HONORABLE BILL FRENZEL

Mr. Chairman, thank you for providing me with this opportunity to testify on S. 1804, the Foreign Sales Corporation Act of 1983.

I commend you and your Committee for scheduling hearings on this vitally important piece of legislation. As you know, identical legislation, H.R. 3810, has been introduced in the House. I hope that both houses will be able to act in an expeditious manner on this legislation.

S. 1804 is designed to replace the Domestic International Sales Corporation provisions (DISC) currently in the Internal Revenue Code with a new, GATT-legal export incentive. The new program, which was introduced after many months of hard work and after close consultations with the Administration, would create Foreign Sales Corporations (FSC's).

There is little need to detail our international woes with DISC. Almost since the day it was enacted 12 years ago, it has been under attack by our trading partners as being a violation of our treaty obligations under the General Agreement on Tariffs and Trade (GATT). In October of 1981, the U.S. made a commitment to the GATT Council to propose legislation which would address the GATT conformity concerns with DISC raised by other GATT members. S. 1804 and H.R. 3810 are designed to fulfill this commitment.

Under the new proposal DISC would be eliminated, except in the case of certain very small Disc's. Current DISC liabilities would be cancelled. DISC would be replaced with a Foreign Sales Corporation. The FSC must be a foreign corporation, and it must maintain an office outside of the U.S. In order to meet GATT requirements, certain foreign presence requirements also must be met.

The legislation is also designed to have approximately the same revenue effect as the current DISC law, and to provide approximately the same amount of tax benefit to FSC users as they currently receive under DISC. This has been accomplished by means of a pricing rule designed generally to provide tax-free status to 17% of the income of the FSC.

S. 1804, and its House companion bill, H.R. 3810, are the result of a process that was initiated last year, and involved the participation of the Treasury Department, the USTR, the Department of Commerce, Members of both the House and the Senate, the representatives of the business community. In this regard, I must pay special tribute to the work of our colleague, David Boren. When the bill was introduced, it was not my first choice, but it was probably the best possible, GATT conforming, bill that could have attracted general support at that time. Now that we have had time to study the proposal more carefully, however, it has become apparent that modifications are necessary.

Under current law, individuals, as well as corporations, are permitted to use DISC and receive DISC benefits. The new proposal, while continuing to permit individuals to be FSC shareholders, denies individuals any direct tax benefits from the FSC. All Members of Congress recognize the important role small businesses, which are often not incorporated, play in developing new export markets. In my judgment, it would be a serious mistake for Congress to enact any proposal which will deny small, unincorporated businesses the benefits provided for in this legislation.

The bill also extends FSC benefits to farm cooperatives. While coops are permitted to use DISC under current law, they are not, as a practical matter, permitted to pass on any of the benefits of DISC back to their members. S. 1804 attempts to address this problem by allowing FSC benefits to be passed through to coop members.

When the FSC legislation was first introduced, I expressed some concern over the manner in which the coop provisions were drafted. Upon further study, it has become apparent that the ambiguities that I had suspected exist do, in fact, exist in the bill. When the coop provision was first considered for inclusion in the bill, it was envisioned that the provision would generally apply to certain limited types of coops, specifically those involved in the export of almonds and citrus products. The provision in the bill, however, applies to all tax-exempt cooperatives.

The coop provisions end up having an effect far broader than originally considered. First, by applying to a broader class of taxpayers than originally thought, the revenue loss from the provision will be substantially higher than the small amount initially projected, perhaps as much as $150 million. More importantly, however, the provision will give farmers who sell their agricultural products to tax-exempt coops the full FSC benefit, while farmers who sell their products to other purchasers in the distribution network will receive no direct FSC benefit. Clearly this is a discriminatory provision.

If we are going to enact a program to provide export benefits to some farmers, it should be provided to all farmers, whether the exporter to whom the agricultural products are sold is a coop or any other form of business. If the spreading of FSC benefits on a broad and equitable basis is too expensive, it may be wise to consider removing the coop provision from this legislation.

One ambiguity which existed under DISC law has been retained in this legislation. That ambiguity involves the eligibility of computer software for FSC treatment. Because of the uncertainty over whether or not software is eligible for FSC treatment, some companies have been taking the DISC benefits, while others have refrained. Software is one of our most sophisticated, most competitive, exports. The FSC legislation should be amended to clarify that software is, in fact, a product that is eligible for FSC treatment.

Although the bill generally attempts to conform as closely as possible to current DISC law with respect to property eligible for FSC treatment, the definition of eligible export property has been broadened somewhat by the addition of natural resources, including coal, as property eligible for FSC treatment. I agree with the addition of coal and other natural resources onto the list of property eligible for FSC treatment, and strongly support their inclusion. I also, however, think that the list should be broadened even further to include the products of what is becoming one of the largest segments of our economy, the service industry.

What I propose is to provide FSC benefits for services that are manufactured and/or produced in the U.S. for consumption abroad. The provision would be limited to those services actually provided in the U.S. Under current law, and under the bill, if a manufacturer produces an automobile, and that automobile is exported, the manufacturer will receive FSC benefits. I do not see any reason why a U.S. advertising company for example, which creates an advertising concept, constructs the layouts for the advertising campaign, and ships the whole thing to a foreign country for use in that country, should be denied the same FSC benefits. Both activities are creating U.S. jobs, and both activities are bringing income into the U.S., helping to solve our balance of trade problems. The service sector of the economy has to [illegible] pete against foreign competitors for foreign business in the same manner as the manufacturing sector of the economy. FSC benefitz should not be granted to one and not the other.

As I stated earlier, S. 1804 is generally a good bill in need of some improvements. I have listed some of the modifications that I believe are necessary in the bill, and it is my understanding that other modifications clarifying and explaining the intent of some of the bill's provisions will be suggested by the Treasury Department and by the USTR. Clarification as to many of the bill's provisions is desperately needed, and the USTR and the Treasury Department are to be commended for working so diligently over the past few months in preparing clarifications of the bill's provisions.

Commendation is also in order for this Committee, for taking the necessary first step toward developing a replacement for the DISC which will comply with our treaty obligations under the GATT. It has been a long process so far, and it will no doubt take quite awhile longer before an acceptable and workable bill can be developed. Your action today in holding a hearing will help to move the process along that much further, and bring closer the day when a GATT legal, meaningful export incentive will be enacted into law.

Senator DANFORTH. I was particularly pleased to hear your view that this is in compliance with GATT. You have followed trade matters, probably more closely than anyone else in the Congress. You are the undisputed expert on the subject in the Congress, and as we proceed, I think that that particular comment of yours deserves special attention from us.

Senator Chafee?

Senator CHAFEE. Mr. Chairman, I would just like to reiterate not only your welcome to our friend, Congressman Frenzel, but also your tribute to him. He is a leader in Congress on increasing our exports, doing what we can to help Americans sell abroad, and he has been indefatigable in this. The fact that he appears here today is further evidence of his deep and effective concern in this area.

He is helping us with other bills in the House and I just wanted to take this opportunity to join in the tribute to the wonderful work he has done. I am glad you are here.

Mr. FRENZEL. Thank you very much, Senator. It is nice to be here. It is very cold in Minnesota. [Laughter.]

Senator DANFORTH. Senator Boren?

Senator BOREN. Mr. Chairman, I want to follow up on the very tough line of questioning that this visitor has received before the committee this morning by joining in the salute to Congressman Frenzel because he really has been, in the forefront. As U.S. Senator Chafee has said, no one in the Congress has done more to call the attention broadly to the American people of the need for us to develop a comprehensive export policy.

When we consider that in the past 20 years we have more than quadrupled that portion of our national income which depends upon international trade, he has really done more than anyone else to alert the people of the country to the fact that our economic future depends upon our ability to compete. He has helped to point out—and he has helped make others in the Congress realize that continuing of the kinds of incentives that we have had in the past through DISC, but doing it in a way that will pass muster with GATT is of extreme importance. I am glad that he has not let any of us forget its importance and has continued to push as hard as he has for us to get on with the business of enacting a DISC proposal that will pass muster.

Again, I want to thank Congressman Frenzel for continuing that effort and being here with us this morning. The four suggestions he outlined to us are very constructive as others, I am sure, that will be included in his full statement.

I appreciate your efforts along this line.

Mr. **Frenzel**. Thank you very much, Senator.

Senator **Danforth**. Senator Grassley.

Senator **Grassley**. Senator Dole and I will verify what Senator Boren and Senator Chafee said, since we served with him in the House. We know from firsthand experience what Congressman Frenzel has done as a legislator.

Senator **Dole**. I don't want to break the chain here, but obviously, you have great influence in the Senate. Now, if you can just work on the House side——[Laughter.]

Senator **Dole**. We would hope to put this in our one package that is going to leave this committee some time soon. We don't know when, but between now and April 1. So, if we can iron out all these problems, we could get it to the House in that fashion, which I think would be helpful to you. Would it not?

Mr. **Frenzel**. I personally would love to see it come to the House. I think it is simply a matter of time until we get our schedules for hearing in order. The mere fact that we are holding these hearings is a great spur to us to get going, and if you should put it in your package, that would certainly precipitate our action.

Our chairman is simply contending with plots of business and a crowded agenda, but that would certainly spur him on.

Senator **Danforth**. Thank you, Bill.

Mr. **Frenzel**. I am going to come back again. I have never been treated so well. [Laughter.]

Senator **Danforth**. We will try to get you a tape.

Mr. **Frenzel**. Thanks very much.

Senator **Danforth**. Mr. Garfield, Mr. Modahl, and Mr. Hardick. We have 16 witnesses left, and I know that Senator Dole is having a luncheon for the Minister of Economy of Switzerland at 12:30. So, we are going to try to hold everybody pretty strictly to the time limit.

Senator **Danforth**. Mr. Garfield.

STATEMENT OF DAVID C. GARFIELD, PRESIDENT, INGERSOLL-RAND CO., ON BEHALF OF THE SPECIAL COMMITTEE FOR U.S. EXPORTS, WASHINGTON, D.C.

Mr. **Garfield**. Thank you, Mr. Chairman.

I do have a longer, written statement.

Senator **Danforth**. All the full statements will be included in the record, so you don't even have to ask.

Mr. **Garfield**. Thank you. I, by the way, am president of Ingersoll-Rand Co., a large exporter, and chairman of the special committee for U.S. exports.

The special committee is a participating group of more than 1,400 business concerns and 90 supporting business associations whose operations and concerns are directed to the export of U.S. products.

Our special committee supports S. 1804 on the basis of the administration's position that it will resolve disputes under the GATT, and continue DISC benefits on at least a revenue neutral fashion.

We surveyed our membership with respect to the proposed legislation, and over 70 percent of the companies that responded to us—and the response was substantial—did favor enactment of S. 1804 as proposed or with manageable technical modifications.

This response was true of companies ranging from under $1 million of export sales to those in the largest category. In light of the clarifying statements provided by the special trade representative and the Treasury Department, since our survey was conducted, we expect that increased favorable response would now be received.

Small business companies indicated a need for more liberal exceptions in order to qualify. That is a point brought out from the administration's witnesses earlier, and we support that. We will continue to work with the administration and Congress to resolve other technical and drafting issues. In particular, reasonable transition and effective date rules must be provided and the specifics of tax treatment in certain cases should be made clear.

The special committee is opposed to considerations of section 2C which treats discount income as subpart (f) income and makes receivables an item of U.S. property where sold to a foreign subsidiary, as a part of the foreign sales corporation legislation.

The special committee is pleased that the administration has taken a first step to resolve a difficult international trade issue, consistent with domestic policy to promote exports. We will be pleased to work in any way we can to reach favorable enactment of this legislation.

In conclusion, we cannot emphasize too strongly the dire necessity at this time of maintaining all the weapons at our command to improve and increase exports in view of the $69.4 billion trade deficit registered in 1983 and the anticipated, and apparently foregone conclusion that that figure will reach $100 billion in the present year. Thank you.

Senator DANFORTH. Thank you, sir.

[The prepared statement of David C. Garfield follows:]

STATEMENT OF DAVID C. GARFIELD, PRESIDENT, INGERSOLL-RAND CO., ON BEHALF OF THE SPECIAL COMMITTEE FOR U.S. EXPORTS

My name is David C. Garfield. I am President of Ingersoll-Rand Company and Chairman of the Special Committee for U.S. Exports. This statement is on behalf of the Special Committee.

The Special Committee is a participating group of more than 1,400 business concerns and 90 supporting business associations whose operations and concerns are directed to the export of U.S. products. The Special Committee's major concerns are with the effect of the U.S. tax system on exports by U.S. businesses and the ability of those businesses to compete in foreign trade in view of the many tax advantages and incentives and direct and indirect subsidies provided for foreign competitors by their governments.

IN GENERAL

The Special Committee supports S. 1804 on the basis of the Administration's position that it will resolve disputes under the GATT and continue present DISC benefits in a revenue neutral fashion.

The U.S. has experienced difficulties in trade negotiations due to the position of various countries that the present DISC legislation is not consistent with the GATT.

Accordingly, the Administration developed the Foreign Sales Corporation legislation, modeled after the territorial systems used by a number of nations such as France, Belgium and the Netherlands and which has been found acceptable under the GATT. The legislation is intended to be consistent with the GATT and continue domestic policy by retaining the export incentive of the DISC without a change in Federal revenues.

SPECIAL COMMITTEE SURVEY

The Special Committee surveyed its membership with respect to the proposed legislation. A copy of the questions and responses broken down by size of the export company is attached Over 70 percent of the companies responding favored enactment of the legislation as proposed or with technical modification. The favorable response to the proposed legislation was true of all sizes of companies ranging from under $1 million to over $20 million of export sales. This response from a wide spectrum of DISC users is a surprisingly favorable response to a change of this magnitude.

CLARIFICATION

In light of the explanatory and clarifying statements provided by the Special Trade Representative and Treasury Department increased favorable response may be expected.

The particular concern raised was the need for clarification of the foreign presence requirement. The Administration's statement contains clarification in this area which should be helpful to companies in evaluating this requirement.

Small business companies indicated a need for more liberal exceptions in order for a number of companies to qualify. The Special Committee urges that Congress make every effort to insure that small business can utilize the new legislation by increasing the amount of the small business exceptions.

There are a number of technical tax issues which the Special Committee has discussed with the Treasury Department and Office of the Special Trade Representative. The Special Committee will continue to work with the Administration and Congressional tax writing committees to resolve technical and drafting issues. In particular, reasonable transition and effective date rules must be provided and the specifics of tax treatment in certain cases should be made clear.

TAX TREATMENT OF RECEIVABLES

The Special Committee is opposed to consideration of section 2(c) of S. 1804, which treats discount income as Subpart F income and makes receivables an item of U.S. property where sold to a foreign subsidiary, as a part of the Foreign Sales Corporation legislation. There is no reason to place an alleged tax reform measure on legislation seeking to achieve a balance between the objections of the GATT, revenue neutrality, and a meaningful export incentive. Any such measure should be separately considered after separate hearings. This provision will have definite impact on exports without regard to foreign sales corporations and therefore, merits such consideration. In particular, the August 4, 1983 effective date is not justified.

CONCLUSION

The Special Committee is pleased that the Administration has taken a first step to resolve a difficult international trade issue consistent with domestic policy to promote exports. We will be pleased to work with the Administration and Congress to reach favorable enactment of this legislation.

We can not emphasize too strongly the dire necessity at this time of maintaining all the weapons at our command to improve and increase exports in view of the $69.4 billion trade deficit in 1983 and anticipated $100 billion deficit in 1984.

1/10/84

SPECIAL COMMITTEE FOR U.S. EXPORTS

DISC ALTERNATIVE SURVEY SUMMARY

Options:
1. Actively support the FSC as proposed.
2. Support the FSC with technical modification.
3. Take no action at this time but support the convening of an International Tax Forum to discuss International Tax Practices of all nations..
4. Retain the DISC recognizing it is counter to the Administration's desire to make export tax incentives compatible with GATT.
5. Other

Dollar Volume of Export Sales	Options				
	1	2	3	4	5
0 - 1 Million	8	2	2	7	1
1 - 5 Million	22	20	2	10	1
5 - 10 Million	11	7	2	4	2
10 - 20 Million	8	5	2	6	0
20+ Million	34	35	10	4	0
No Volume Stated	11	4	2	7	1
TOTAL	94	73	20	38	5

SPECIAL COMMITTEE FOR U.S. EXPORTS

DISC ALTERNATIVE

SURVEY

Assuming the Administration position is correct in that the DISC must be replaced by a Foreign Sales Corporation (FSC), and that the proposed alternative contains, at this time, the following features:

- Forgiveness of the present accumulated DISC deferral
- A reduction in tax on export sales instead of the tax deferral under DISC
- An unclear definition of foreign prescence and activity
- Concern for the adequacy of provisions for Small Business
- Provisions for the tax treatment in factoring of receivables

OUR PREFERENCE IS:

☐ Actively support the FSC as proposed.

☐ Support the FSC with technical modification. (Please comment below on specific technical issue.)

☐ Take no action at this time but support the convening of an International Tax Forum to discuss International Tax Practices of all nations.

☐ Retain the DISC recognizing it is counter to the Administration's desire to make export tax incentives compatible with GATT.

☐ Other Action (please specify).

COMMENTS: ______________________________

____

____

Dollar Volume of Export Sales $______________

Please Check One:

☐ This information may be used only in composite form so as not to identify the specific source.

☐ This information may be used as separate data as deemed appropriate by the Special Committee for U.S. Exports.

(Optional) Name ______________________
Company ______________________
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Senator **Danforth**. Mr. Modahl.

STATEMENT OF WILLIAM B. MODAHL, MANAGER OF TAX AFFAIRS, DIGITAL EQUIPMENT CORP., ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL, INC., WASHINGTON, D.C.

Mr. **Modahl**. My name is Bill Modahl. I appear on behalf of the National Foreign Trade Council as member of its tax committee. I am manager of tax affairs for Digital Equipment Corporation, the world's second largest computer company.

Nearly 40 percent of Digital's sales are to overseas customers. The council is a private, nonprofit organization which represents more than 600 companies engaged in international trade and investment. The council supports Senate 1804 as a framework for the resolution of questions that have arisen with respect to the DISC provisions of the tax law.

DISC was enacted in recognition of the importance of exports to our economy. It encourages business managers to make the extra effort necessary to sell overseas. While DISC has been successful in this, it has also been challenged under GATT. In order to address the diplomatic problems raised by the trading partners, the NFTC supports the effort to enact a GATT consistent substantive. At a minimum, however, any substitute must perform the same function as the present DISC.

That is, it should partially, at least, restore the competitive balance that is upset by foreign tax and trade practices that far outweigh the DISC benefits.

DISC means exports, and exports mean jobs. Based on Commerce and Treasury figures, in 1981 DISC accounted for approximately one-quarter million U.S. jobs. While much of the U.S. economy is rebounding, the export sector is not. The Commerce Department has described the drop in U.S. exports as catastrophic and has suggested that the optimistic estimates of future growth have overlooked this effect.

According to Commerce, the current GNP growth of 4½ percent would be 6.7 percent but for the drop in exports. Senate 1804 was designed as a revenue neutral DISC substitute.

The council believes that circumstances would justify an expansion of existing provisions, which were modest to begin with and have been cut back on several occasions. However, under the revenue constraints, DISC provides a reasonable framework for a DISC replacement. Senate 1804 could be significantly improved by the correction of several technical items, and the elimination of the unrelated issue of factoring of trade receivables.

We have outlined our concerns in a written statement and would be happy to provide assistance. Thank you.

Senator **Danforth**. Thank you, sir.

[The prepared statement of William B. Modahl follows:]

STATEMENT OF WILLIAM B. MODAHL, MANAGER, TAX AFFAIRS DIGITAL EQUIPMENT CORP., ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

My name is William B. Modahl. I appear on behalf of the National Foreign Trade Council as a member of its Tax Committee. I am Manager, Tax Affairs for Digital Equipment Corporation, the world's second largest computer company. The Council is a private, non-profit organization which represents more than 600 companies engaged in international trade and investment. The Council supports S. 1804 as a framework for the resolution of certain questions that have arisen with respect to the DISC provisions of the tax law.

The Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code were enacted in 1971 to enhance the competitiveness of U.S. exporters. While DISC has succeeded in improving U.S. competitiveness, it has also been a source of controversy since its enactment. In particular, DISC has been challenged as an export subsidy that is inconsistent with the General Agreement on Tariffs and Trade (GATT), to which the U.S. is a signatory. Although the United States has never conceded the question of whether DISC is consistent with our GATT obligations, the U.S. Trade Representative has assured the GATT Council that the administration would propose legislation to "address the concerns" of the complaining GATT members. S. 1804, the Foreign Sales Corporation Act, is the product of that promise.

In order to address the diplomatic problems raised by our trading partners, the NFTC supports the effort to enact a more clearly GATT-consistent substitute. Of course, any final substitute must perform the same function as that performed by the current DISC; i.e., to partially restore the competitive balance that is upset by foreign tax practices. To be effective, any substitute should give U.S. exporters at least the same level of benefit as that which currently comes from DISC.

DISC AND EXPORTS

DISC has been very successful at encouraging U.S. exports. In its 1983 report on the 1981 DISC year, the Treasury concluded that DISC accounted for increased exports of $7.2–$11.0 billion that year. In addition, a recent Price Waterhouse study has suggested that this increase in exports may generate sufficient economic activity to result in a net revenue gain from DISC. The number of DISCs has grown dramatically from about 3,500 in 1972 to more than 17,000 in 1983.

At Digital almost 40 percent of our sales are overseas. Our international business has helped us to achieve global economies of scale necessary to being competitive at home and abroad. For example. without this volume, we would be severely limited in our ability to finance our increasing levels of R&D. DISC has helped expand exports at Digital. By making such sales incrementally more profitable, it gives managers an incentive to make the extra effort needed to sell overseas. Digital's experience is not an uncommon one. Rather, it is a real-life case that supports the Treasury's overall view of the relationship of DISC to high technology manufacturers. As the Treasury's 1981 Annual Report demonstrates, High technology exports are quite sensitive to changes in DISC treatment.

EXPORTS AND U.S. JOBS

A recent report from the Commerce Department's Office of Trade and Investment Analysis demonstrates that the link between U.S. export performance and U.S. employment is far greater than generally understood. For example, export-related jobs account for one in eight manufacturing jobs and one in six jobs in non-manufactured goods. From 1977 to 1980 export related job growth accounted for 30 percent of all private sector growth. The drop in exports from 1980–1982 accounted for 40 percent of the increase in U.S. unemployment. Based on Commerce Department and Treasury figures, in 1981 DISC accounted for approximately a quarter of a million jobs for Americans.

With this close relationship of jobs and exports in mind, the precipitous decline in the U.S. trade position is disturbing. The NFTC's Balance of Payments Committee estimates that the merchandise trade deficit will be $59 billion for 1983 and $100 billion for 1984. The Commerce Department has described the drop in U.S. exports as "catastrophic," and has suggested that the optimistic estimates of robust economic growth have overlooked this effect. It is a matter of high national priority to expand exports. The role that DISC has played in supporting exports and export related employment argues strongly for the continuation or expansion of the current level of benefits for exports. Any DISC substitute should preserve these benefits and should be designed so as to minimize the need to create jobs outside the U.S.

DISC AND FOREIGN TAX PRACTICES

Among the reasons American exporters have difficulty meeting foreign competition are the tax and non-tax export subsidies employed by our trading competitors. Practices such as direct agricultural subsidies and industrial targeting policies can give foreign competitors an unfair advantage over U.S. exporters. Further, foreign governments provide both explicit and subtle tax policies that provide special advantages to their exporters. Unfortunately, many of these practices are either not covered under the GATT rules, or are expressly permitted as exceptions to those rules.

For example, some countries have adopted a "territorial" taxing concept under which a nation does not generally tax the foreign source income of their companies. To the extent export sales generate foreign source income, these companies pay little or no home country tax. By contrast, U.S. companies pay a U.S. federal tax of up to 46 percent on export income.

Another tax advantage many foreign competitors hold is their governments' heavy reliance on national sales taxes or value-added taxes. These taxes are generally rebated on export sales, and, consequently, there is no domestic tax burden imposed on products destined for export.

Finally, in my experience, foreign tax officials, as a matter of export policy, frequently do not rigorously examine the export-related transactions of their nationals. By contrast the U.S. zealously enforces the arm's-length standard for transactions among related parties. While the NFTC does not mean to suggest that U.S. tax adminstrators should depart from their high standards, it is important to recognize the realities of the marketplace.

Congress enacted the DISC legislation in 1971 to offset, at least in part, these foreign tax advantages. In the current parlance, the effort was made toward "leveling the playing field."

S. 1804, FOREIGN SALES CORPORATION

In considering the merits of S. 1804, one must recognize the groundrules for its construction. To satisfy our trading partners, the legislation must be consistent with GATT. Because of the federal budget deficit, the legislation must be revenue neutral. If these limits were not essential, the Council would prefer an expansion of the existing benefits to both present users and the services sector of the economy. Nonetheless, under these constraints, S. 1804 provides a reasonable framework for a DISC replacement.

DISC AND GATT

The consistency of the DISC with the GATT rule has been challenged since the DISC was adopted in 1971. Arguing that the GATT rules permit the rebate of indirect taxes (e.g., sales taxes and value-added taxes), but not direct taxes (e.g., income and payroll taxes), the European Communities and others sought, and in 1976 obtained, a GATT panel ruling against the DISC. The United States responded by challenging the tax practices of France, Belgium and the Netherlands under which foreign subsidiaries are not generally taxed on foreign source income. The United States was also successful in obtaining a favorable GATT panel ruling against the three "territorial" tax practices.

These disputes have been linked procedurally since 1976. The United States took the position that the GATT panel report on DISC should not be adopted by the GATT Council, thereby making it a binding GATT ruling, unless the GATT Council adopted the reports on France, Belgium and the Netherlands.

On December 1, 1981 the GATT Council adopted all four of the panel reports. Along with these reports, however, the GATT Council also adopted a set of principles that have collectively become known as the "qualifier." The effect of the qualifier was to permit the continued use of territorial taxing concepts.

Under the rules of the qualifier, if arm's-length pricing is observed, there is no obligation to tax economic processes that take place beyond a country's territorial limits. In addition, the qualifier expressly acknowledged that any country may adopt methods to reduce international double taxation.

The qualifer set the groundrules for a DISC replacement. Consequently, the proposed legislation permits a reduction of tax only with respect to income derived from economic processes outside the territorial limits of the U.S. Since the qualifier expressly permits methods designed to reduce international double taxation, the tax benefit is an exemption from tax, rather than the challenged tax deferral method of DISC.

The FSC legislation relies upon the rules of section 482 of the Internal Revenue Code for the determination of what income is earned by the FSC. However, for administrative convenience, taxpayers are permitted to rely upon the performance of certain activities outside the U.S. to qualify for the assignment of a prescribed amount of income. A portion of the income earned under the administrative rules is deemed to be U.S. source and a portion is foreign source. Subject to certain limits, the foreign source income is exempt from U.S. taxation.

Although the legislation includes the possibility of a commission relationship between FSC and its related supplier, it is not clear how a commission agent would qualify under the administrative convenience rules. These presence tests need comprehensive clarification.

In addition to the foregoing general observations on the legislation, a number of technical tax issues has arisen. The following are the major ones:

1. Determination of source for non-exempt foreign trade income (FTI).—Under S. 1804 only a portion of FTI would be exempt. The remainder, non-exempt FTI, would be currently taxed and treated as U.S. source income. The automatic characterization of this income as U.S. source may adversely affect some taxpayers. The source of this income should be determined under the general provisions of the Internal Revenue Code.

2. Foreign tax credit with respect to non-exempt FTI.—It appears that no foreign tax credit will be available for any FTI. While we can understand the reason for denying the foreign tax credit for exempt income, to the extent non-exempt FTI is subject to a creditable foreign tax, the foreign tax credit should be allowed.

3. Other tax credits.—Proposed IRC section 921(c) would deny FSCs a number of tax credits, including the investment tax credit. We see no reason for the denial of credits that are properly apportioned to FTI that is not exempt.

4. Factoring.—Section (c) of the bill would adversely affect the factoring of trade receivables and is generally unrelated to the FSC issue. This is a highly technical, complex issue. The factoring issue should be carefully considered for its negative effects on wholly appropriate business practices. These non-tax motivated transactions include factoring receivables of a manufacturing affiliate to a financing affiliate within the same foreign country, or factoring for the purpose of centralization of currency fluctuation risks. Since the question of factoring has no bearing whatsoever on the FSC issue, any changes should be considered separately.

5. Cliff on disqualification.—In order to use the administrative convenience rules, a taxpayer must perform 50 percent or 85 percent of certain direct costs. We are disturbed about the prospect that a taxpayer might inadvertently miss the qualification by perhaps a fraction of a percentage point. Rather than a complete denial of benefits, consideration should be given to a procedure that would allow a proportionate reduction of tax benefit in the event a taxpayer fails to meet the prescribed percentage levels.

6. Transition rules.—Special care must be taken to assure that any transition from a DISC system to a FSC system is a smooth one. In particular, all DISCs should not be required to meet the export assets test of § 992 as of the same date. Further, DISC benefits should be continued for those long term contracts entered into prior to enactment of this legislation.

In conclusion, the Council supports S. 1804 as a framework for the resolution of the trade related disputes that have arisen under DISC.

Senator **Danforth**. Mr. Hardiek.

STATEMENT OF BERNARD L. HARDIEK, DIRECTOR OF TAXES, DEERE & CO., MOLINE, ILL., ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE, WASHINGTON, D.C.

Mr. **Hardiek**. I am the director of taxes for Deere & Co. I am here today to express the support of the Emergency Committee for American Trade, ECAT, for Senate bill 1804, the Foreign Sales Corporation Act.

We believe it is vital that the United States conform its export trade incentive to the rules of the General Agreement on Tariffs and Trade in order to restore the credibility of the U.S. international economic leadership. Enactment of Senate bill 1804 will do this without any increase in the Federal budget deficit.

While the bill will cause ECAT members considerable difficulty in meeting the required foreign presence rules, we believe these rules can be met, and Treasury's implementing regulations follow the intent and spirit of the bill. We are concerned, however, that the foreign sales corporation can be totally disqualified, and therefore no benefit if unintentional shortfalls—admitting the 50 percent or 85 percent of foreign activity requirements occur. And we have a recommendation in our statement to provide for a partial benefit where a company fails to meet the entire foreign activity requirement.

Senate bill 1804 also contains a very controversial provision, which requires a U.S. corporation to treat a sale of receivables to a related foreign corporation as though no sale had taken place and instead a dividend had been received by the U.S. corporation. There is no valid business reason and no technical basis for this provision. It has already affected long-standing financial arrangements because it has a retroactive effective date of August 4, 1983.

ECAT strongly urges that this provision be deleted because it would reduce the economic incentives to export and for a number of ECAT members and will certainly greatly reduce business support for this bill.

Senator **DANFORTH**. Thank you, gentlemen.

[The prepared statement of Bernard L. Hardiek follows:]

STATEMENT OF BERNARD L. HARDIEK, DIRECTOR OF TAXES, DEERE & CO., ON BEHALF OF EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. Chairman, Good Morning. I am Bernard L. Hardiek, Director of Taxes for Deere & Company, and am here today on behalf of the Emergency Committee for American Trade (ECAT) to express its support for S. 1804, a bill that would replace the DISC with a new Foreign Sales Corporation (FSC). ECAT is an organization of the heads of 63 large U.S. firms with extensive overseas business operations. Worldwide sales of ECAT member companies, including Deere & Company, total about $700 billion annually, and they employ over 5 million workers.

S. 1804 is of significant interest to ECAT members. They are among the leading U.S. exporters. ECAT's interest in the FSC issue, however, is broader than the immediate economic interests inherent in the bill's provisions. We are firm believers in and supporters of the GATT international trading system. It is a system that greatly benefits the United States and its trading partners. It is also a system under great stress from demands around the world for domestic protection from international competition. Should such demands be met by measures outside of the rules of the GATT, then international economic anarchy is likely to be the rule. We believe it important, therefore, that the United States continue its vital leadership role in the GATT in seeking international conformity to the international trading rules.

The ability of the United States to lead, however, is weakened to the extent that the United States has formally been found to be living outside the export subsidy rules of the GATT through maintenance of the DISC. Passage of S. 1804 would conform the U.S. export tax incentive to the Gatt rules thereby removing a significant irritant and barrier to continuing U.S. international economic leadership in seeking the lowering of international trade barriers and international adherence to GATT rules. Enactment of the bill would not add to the federal budget deficit. We strongly urge its enactment.

A feature of S. 1804 is its several requirements for the establishment of a foreign economic presence in order to qualify for the administrative pricing rules. While a number of these requirements are troublesome and will cause considerable restructuring of export activities of our member firms, we believe that the requirements are generally reasonable and can be met if the implementing regulations are drafted by Treasury following the intent and the spirit of S. 1804.

We do have significant concerns over some of the bill's other provisions. Principal among these are the lack of a solution to IRS audit problems which could completely disqualify a Foreign Sales Corporation and the provisions concerning the sale of receivables to foreign subsidiaries.

ECAT member companies are concerned with the all-or-nothing approach contained in the foreign presence requirements. A company is required to perform 50 percent of five economic activities or 85 percent of two economic activities outside the U.S. in order to qualify as a Foreign Sales Corporation. If, in good faith, a corporation believes it has met the 50 percent requirement but an IRS audit identifies additonal expenses allocable to the FSC's activities which were not incurred overseas so that the corporation has now performed 49 percent of the five activities overseas, the corporation is totally disqualified and is not entitled to any of the benefits of this bill on its export sales. ECAT encourages the Senate Finance Committee to add a provision that would allow a partial benefit in those cases where the shortfall in meeting the foreign economic presence is not deliberate nor recurring after the IRS audit. The current DISC provisions recognize the need to address this problem and allow for a distribution of assets in certain circumstances to enable the DISC to cope with unforeseen problems in meeting the 95 percent test on qualified income and assets.

We recommend that a corporation be entitled to the full benefits of the Foreign Sales Corporation Act if the required percentage of activities was performed overseas in the two prior or subsequent years; in the alternative, the corporation would be entitled to a benefit equal to the actual percentage of activites performed overseas divided by the statutory percentage of 50 or 85 percent.

The provision which treats the sale of foreign receivables by a U.S. corporation as a dividend sharply reduces the support of this bill by the business community and should be deleted. The sale is treated as a dividend even though the transaction is clearly a sale of receivables and is similar to the normal sales of receivables which take place every day between corporations and financial institutions. The devastating effect of this provision can be demonstrated as follows:

Assume a U.S. corporation sells inventory manufactured in the U.S. to an Australian corporation for $10,000,000.00, allowing 150 days interest-free terms, which is common in the industry. The U.S. corporation then sells the $10,000,000.00 note received from the Australian corporation without recourse to its Belgium subsidiary for $9,500.000.00 (the present value of the receivable). The Belgium subsidiary collects the receivable 150 days later and receives $10,000,000.00. Under current law, this transaction would not result in any increase in the U.S. corporation's tax. The proposed law would affect the U.S. corporation in the following manner:

Subpart F income increased $500,000.00.

U.S. tax @ 46%.

The difference between the amount the Belgium subsidiary collected on the note ($10,000,000.00) and its cost for the note ($9,500,000.00) is $500,000 and would be considered Subpart F income taxable as a dividend to the U.S. parent.

Dividend income $9,500,000.00.

U.S. tax @ 46%. $4,370,000.00.

The sale of the note to the Belgium subsidiary is treated as an "investment in U.S. property" even though it is a note of a foreign corporation. The "investment in U.S. property" is then treated as a dividend to the U.S. parent to the extent of the Belgium subsidiary's previously untaxed earnings and profits even though the transaction is actually the sale of an asset.

The net effect of the proposed change in the tax law is to impose an additional $4,600,000 in U.S. taxes on the corporation which sold a foreign receivable generated by goods exported from the U.S. at a loss of $500,000. It is indeed ironic that a bill designed to encourage exports exacts such a tremendous tax penalty where none existed previously.

The proposal has already disrupted long-standing financing arrangements for export sales because the provision is effective for all receivables sold after August 4, 1983 even though all other provisions of the bill are effective after December 31, 1983. This August 4, 1983, effective date already has created significant difficulties and additional costs in Deere & Company's financial and export activities.

A second part of that proposal would also treat the discount income as Subpart F income when one foreign corporation purchased receivables from a related foreign corporation. This provision has no relationship at all to the replacement of the DISC since it applies to receivables generated by non U.S. exports which were never covered by the DISC. It will impede centralized foreign currency management practices of multi-national corporations which are used to hedge their exposure to foreign currency fluctuations. A substantial U.S. tax liability could be incurred as a result of uncontrollable changes in foreign currency rates. This provision would significantly penalize legitimate, cost effective foreign currency management at a foreign location. These proposals are not needed to make the Foreign Sales Corporation Act revenue neutral but instead are very controversial and were not included in three previous drafts of the Foreign Sales Corporation circulated by the Treasury Department. If they are to be considered at all, they should be the subject of a separate bill instead of complicating an already delicate situation requiring the cooperation of Congress, Treasury, the U.S. Trade Representative's Office and exporters.

We also are concerned with the provisions of the bill that will not allow a foreign tax credit for both exempt and non-exempt income earned by the proposed FSC.

This could lead to double taxation and we would prefer to see this provision deleted from the bill.

On behalf of ECAT and Deere & Company, I sincerely appreciate the opportunity to present these views to you today. The business community is indebted to the Treasury Department and the U.S. Trade Representative's office for their cooperation and open sharing of views during the drafting of this legislation. Many of the delicate problems have already been resolved and we hope that our comments can lead to the implementation of a replacement for DISC which will continue to provide a significant incentive for exports.

Senator DANFORTH. Do you believe that as a general rule the foreign presence requirements under the FSC bill would provide for serious hurdles for American business? Would that require changes in activities and operations, or would this be something that would be readily accomplished by American business?

Mr. GARFIELD. I don't believe there is any problem whatsoever with regard to the larger firms. The whole problem centers on the small firms, and I do think that there should be an initiative to raise the limit of this exemption. I think that $2½ million export revenues is really a very small sum. And since the criteria here is to try to do something for exports, it should be made as large as we can base into at this time.

Senator DANFORTH. Mr. Modahl.

Mr. MODAHL. I think that I would agree with Mr. Garfield. These foreign provisions, when you mention the word foreign—they sound complicated—but by and large, for larger companies, they are workable. Some concern I have might be in relation to the earlier testimony. We heard about exchange of information agreements. Under the proposed legislation, we would provide thorough information, and that is not a problem at all. But I think companies should be relatively free to select the site of their overseas operation to combine with this, and their ability to use the DISC shouldn't turn on the existence of certain treaties that are presently under negotiation. So, I would urge that that area be treated with some caution.

Senator DANFORTH. Mr. Hardiek?

Mr. HARDIEK. Up to this point, we have had the opportunity to comment on approximately three drafts that Treasury has already had, and we have found them receptive to the business community's concerns. If that type of exchange of information continues, we believe we can work out all the problems that are there right now.

Senator DANFORTH. Thank you. Senator Grassley?

Senator GRASSLEY. Mr. Hardiek, how much of this involves domestic manufacture?

Mr. HARDIEK. Approximately 40 percent.

Senator GRASSLEY. How much would exports be reduced without DISC?

Mr. HARDIEK. That is very difficult to answer, Senator Grassley. It certainly would be less because of the fact that our taxes would increase and there would be less funds available with which to support that manufacturing, but I cannot give you an opinion at this point. We have not really done a study of that to determine how much it would decrease.

Senator GRASSLEY. Will the substitution of FSC for DISC considering start up time—reduce exports temporarily?

Mr. Hardiek. No. I do not think it would as long as there is a smooth transition between the DISC and FSC and that there are no subsidy barriers or import barriers placed by the members of our trading community and the European Community.

Senator Grassley. From the standpoint of administrative costs that apply to the DISC, do you have any idea what the costs would appear to apply to——

Mr. Hardiek. The Treasury rules have been changing substantially. At one point, we thought that we would have to transfer at least 50 people overseas in order to meet those requirements, but as the drafts between the U.S. Trade Representative's Office and Treasury have evolved, those requirements have become substantially less.

At this point, again, we do not have enough information about what the final rules will be to provide that information to you.

Senator Grassley. Mr. Chairman, I have finished my questions.

Senator Danforth. Thank you. Senator Dole has no questions. Gentlemen, thank you very much.

Mr. Howard, Mr. Heyde, Mr. Howard—two Mr. Howards—and Mr. Reed.

STATEMENT OF FREDERIC K. HOWARD, JOHNSON & HIGGINS, NEW YORK, N.Y., ON BEHALF OF THE COALITION OF SERVICE INDUSTRIES, WASHINGTON, D.C.

Mr. F. Howard. My name is Frederic Howard. I am vice president and assistant treasurer of Johnson & Higgins. I am here today on behalf of the Coalition of Service Industries, an organization you probably have not heard from before.

It was formed in 1982. It now comprises 29 major service industries, industries like AT&T, CBS, Merrill Lynch, IBM, Sears Roebuck, Young and Rubikon. The primary purpose of the coalition is really to foster an awareness of the importance of service industries in the world economy. I must say the remarks—I am not the Mr. Howard who was mentioned earlier by Senator Chafee—but based on the testimony reported by Mr. Chafee, I would certainly accept him as a member of my family.

And my message today is really the philosophy expressed by Senator Chafee earlier. If this administration and the Congress really believe that this does foster exports, and contributes to improving our balance of payments deficit, and helps American companies in foreign competition abroad, then there is no reason why it should not be extended to services.

I think the only reason it probably wasn't in the old days was that it was just an oversight. But we all know the services are the fastest growing segment of the export economy. They relate to knowledge, business information, and high technology. Export of services creates jobs at home. Export services create income as do goods and export industries have to compete in the world economy just like any other industry.

Now, we believe that USTR and also the Commerce Department are behind the extension of a DISC or FSC to services. It has only been the Treasury Department that, I think, has resisted this kind of an initiative. I have to see a Treasury Department study, though, that really backs their assertion that this would be a great revenue cost to the Treasury.

And looking at the revenue costs, I think, is really only looking at one side of the equation, as Senator Chafee indicated earlier. We believe the revenue cost would be very small in comparison to what is asserted for the existing DISC. My recommendation, therefore, is that the Congress modify the existing DISC or FSC to give equal treatment to service industries, and we would be glad to work with this committee or any committee or the administration to provide all the kinds of protection that I think you want so that service industries will be accorded equal treament and will not be creating any abuses. Thank you, sir.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Frederic K. Howard follows:]

STATEMENT OF FREDERIC K. HOWARD ON THE TREATMENT OF FOREIGN EXPORT INCOME

I am Frederic K. Howard, Vice President and Assistant Treasurer of Johnson & Higgins. I am appearing here today on behalf of the Coalition of Services Industries, Inc. (The "CSI").

The CSI consists of 29 major U.S. service corporations which represent a wide cross-section of the service industries of the United States, including brokerage, consulting, and telecommunications.

The CSI was formed in 1982 (1) to foster a public awareness and understanding of the enormous contribution that these industries make to U.S.-economic growth, job-creation, and balance of payments, (2) to identify and address public policy issues affecting the growth of service industries, and (3) to contribute to the formulation of a coherent national policy that permits service industries to compete with foreigners on an equal basis in the international service market.

Private sector services industries are labor-intensive. They provide jobs for 55 million Americans, over half of the American work force. Chart I. These same industries generated 55 percent of the 1981 gross national product (GNP) and over 60 percent of the total private sector GNP. Chart II.

These same industries have made the United States the world's leading exporter of services. The export of these services has produced a long-term, positive impact on U.S. balance of payments. Surpluses from the export of services have consistently reduced merchandise deficits in our balance of payments. Chart III.

The Congress of the United States recently recognized the enormous contribution that U.S. service industries can and are making to the economic well-being of the U.S. In the Export Trading Company Act of 1982, Congress defined export trade to include both the export services and the export goods.

The purpose of DISC and its replacement is to formulate the export of products produced in the U.S., thereby (1) creating or maintaining jobs for Americans who produce or furnish those products, (2) reducing balance-of-payment deficits, and (3) offsetting export tax benefits granted to foreign competitors. We wholeheartedly support these admirable goals and the efforts of the Congress and the Administration to fashion an export incentive program that satisfies our treaty obligations and the demands of the international marketplace.

However, export services create or maintain jobs for the Americans who furnish those services, just like export products create or maintain jobs for Americans who manufacture those products.

The income realized from the sale of export services reduces balance-of-payments deficits, just like income realized from sales of export property.

Moreover, U.S. services industries are competing for a share of the international services market with foreign competition that receives foreign export tax benefits and other preferential treatment, just like foreign competitors of U.S. manufacturers.

Nonetheless, the U.S. service industries are not accorded equal treatment with other sectors of the U.S. economy by the Domestic International Sales Corporation (DISC) export incentive program.

Specifically, the DISC program is designed to defer a certain portion of the export income realized by a U.S. person from the sale or lease of export property (tangible personal property produced or manufactured in the U.S.) for ultimate consumption or use outside the U.S. As such, virtually all export sales of such property (with some exception) can qualify for DISC benefits if properly structured.

By contrast, nearly all export service income realized by U.S. persons is excluded from DISC benefits. Export services income includes income from the sale of services performed in the U.S. (1) that are consumed abroad, (2) that facilitate the consumption abroad of export property or services, (3) that create intangible property (such as advertising spots, or patents) sold or leased for consumption abroad, or (4) that are performed abroad by U.S. based-persons.

The only export service income that qualifies for DISC benefits are engineering and architectural services on construction projects, limited managerial services, and some services related and subsidiary to the sale of export property. Thus, export income realized from performing consulting services, educational services, financial services, food processing services, health services, insurance brokerage services, insurance services on foreign risks, management services, maintenance services that are not related or subsidiary, private postal services, stock brokerage services, telecommunications and data processing services, transportation services, travel services, to name a few, will ordinarily not be eligible for DISC benefits.

The Foreign Sales Corporation Act (FSC), the proposed replacement to DISC, would exclude virtually the same export services that are excluded from DISC benefits.

For the reasons stated above we respectfully recommend that your Committee modify the DISC and FSC provisions to extend the benefits provided to the export of services as well as goods. We firmly believe that increasing these benefits to cover the service sector will greatly benefit the economy as a whole.

We on the Coalition of Services Industries Tax Task Force stand ready and willing to assist your Committee in any way possible.

Thank you for the opportunity to present these remarks.

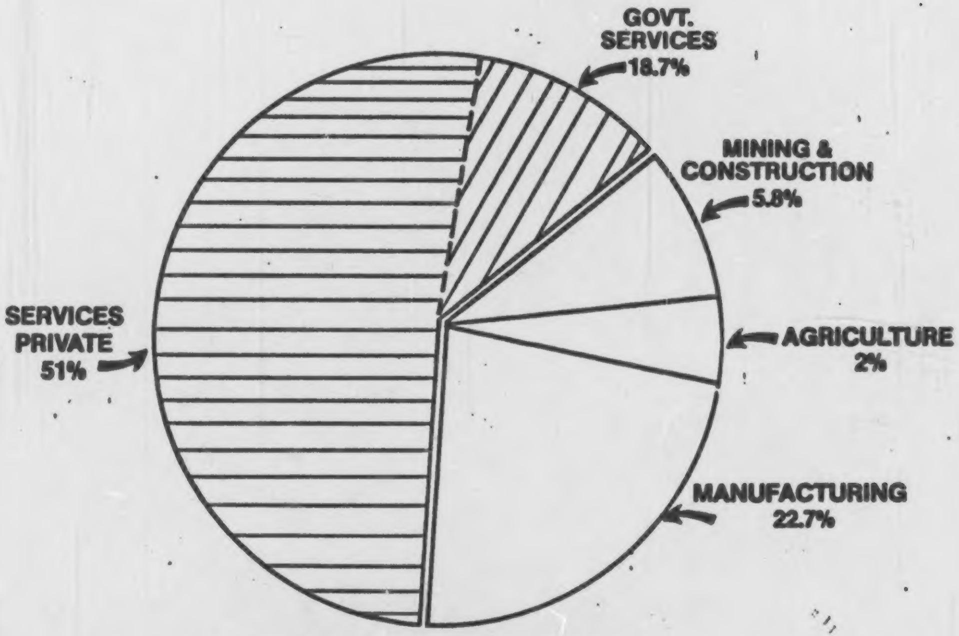
APPENDIX

Coalition of Service Industries - Membership List

American Express
American International Group
American Medical International
American Telephone and Telegraph
ARA Services
Bank of America
Bechtel Power
Beneficial Finance
CBS, Inc.
Chase Manhattan Bank NA
Cigna (INA)
Citibank NA
City Investing
Continental Insurance
Deloitte Haskins & Sells
Flexi-Van Corp.
Fluor
Intercontinental Hotels
IBM
Interpublic Groups of Companies Inc.
Johnson and Higgins
Manpower Inc.
March & McLennan
Merrill Lynch
Peat Marwick & Mitchell
Philbro
Sea-Land Industries Inc.
Sears Roebuck
Young & Rubicam

CHART I

1981 DISTRIBUTION OF FULL TIME EQUIVALENT EMPLOYEES AMONG INDUSTRIES

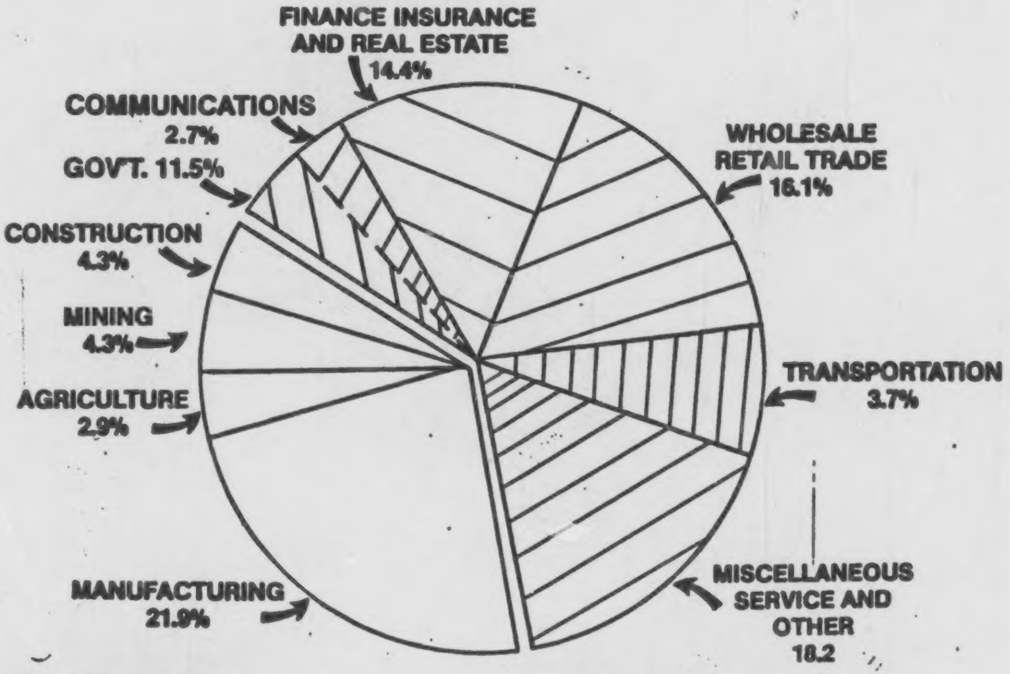


U.S. DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS
SURVEY OF CURRENT BUSINESS, JULY 1982, TABLE 6.8B

CHART II

COMPOSITION OF GROSS NATIONAL PRODUCT 1981 (1)

(BILLIONS OF CURRENT DOLLARS)



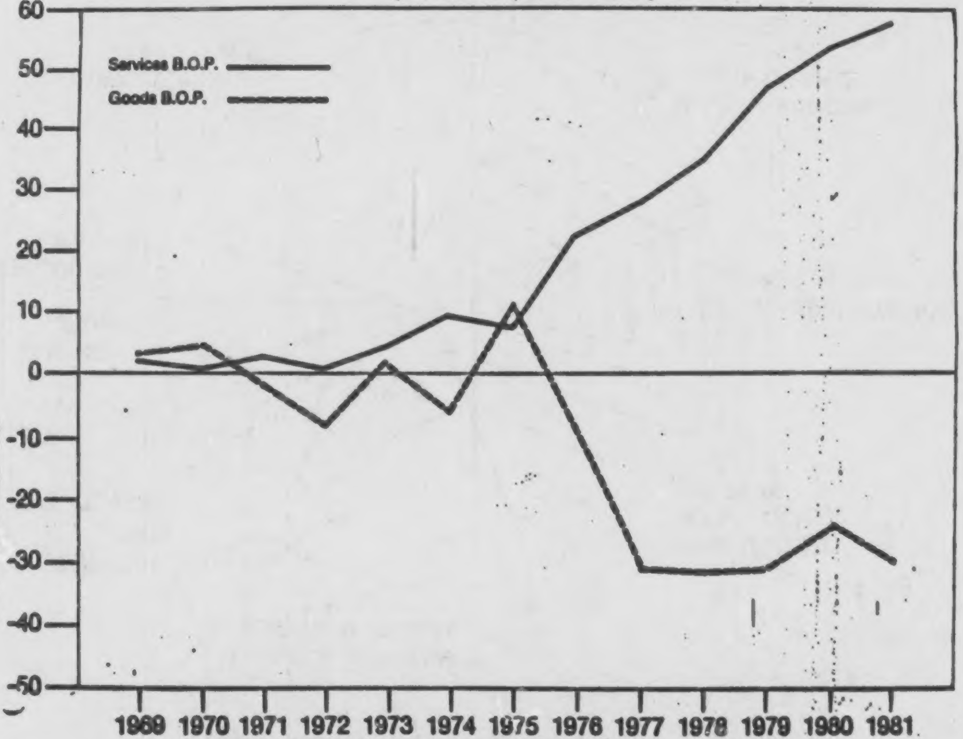
ALL SERVICES 66.6%
GOVERNMENT 11.5%

U.S. DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS
SURVEY OF CURRENT BUSINESS, JULY 1982, p. 78

CHART III

U.S. BALANCE OF TRADE IN GOODS & SERVICES

(Billions of Current Dollars)



Source: U.S. Dept. of Commerce, Survey of Current Business, July 1982, Table 4.1, p. 65.

Senator DANFORTH. Mr. Heyde.

STATEMENT OF ROBERT D. HEYDE, CHAIRMAN, DISC TASK FORCE, U.S. COUNCIL FOR INTERNATIONAL BUSINESS, WASHINGTON, D.C.

Mr. HEYDE. Thank you, Mr. Chairman.

My name is Robert Heyde. I am chairman of the DISC task force of the U.S. Council for International Business, and a member of the law firm of Miller and Chevalier.

The membership of the U.S. Council consists of substantially all of the major U.S. exporters, and we are the U.S. arm of the International Chamber of Commerce.

Our membership has a firm belief in free trade, but above all in fair trade. And it is from this starting point that we approach S. 1804. The economic evidence is indisputable—that U.S. exports do need help. While the strong U.S. dollar has been a major contributor to this situation, it is clear that exports are affected by tax policy. We believe that the foreign sales corporation is the minimal step toward creating a favorable tax environment that will help U.S. exports on a permanent basis.

The foreign sales corporation, however, is not an export subsidy, when compared to the European territorial tax systems. It is instead a step toward such a system and therefore toward the goal of fair trade.

We believe that the DISC provisions, while not perfect, have served as an effective export policy. The foreign sales corporation provisions will do likewise.

We also believe that the factoring of trade receivables provision of the bill should be stricken, eliminating this controversial technical provision from the consideration of what a sound export tax policy should be. One final point. We see an urgency in the prompt enactment of this legislation. We support the extension of export tax policy to services and we support an early consideration by the Congress of the bill that will cover services. Thank you.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Robert D. Heyde follows:]

STATEMENT
# of the
UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

S. 1804

A Bill to amend the Internal Revenue
Code of 1954 with respect to the tax
treatment of foreign sales corporations.

by

Robert D. Heyde
Chairman, DISC Task Force
Committee on Taxation

November 18, 1983

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS
1212 Avenue of the Americas, New York, New York 10036. (212) 354-4480

STATEMENT OF ROBERT D. HEYDE
BEFORE THE COMMITTEE ON FINANCE

My name is Robert D. Heyde. I am the Chairman of the DISC Task Force of the United States Council for International Business ("Council") and a member of the Council's Tax Committee.

I am testifying before you today to present the Council's strong support for S. 1804. The Council finds the overall proposal a workable and acceptable replacement for the current Domestic International Sales Corporation tax rules, but believes that some provisions of the Bill should be modified.

The United States Council for International Business is a business policy-making organization whose membership includes some 260 United States corporations involved in international trade. The Council functions primarily as the United States arm of the Paris-based International Chamber of Commerce. The Council is also a spokesperson for American business in international forums such as the United Nations, the Organization for Economic Cooperation and Development, and the International Labor Organization.

Exports are vital to the United States economy. Expanded exports result in increased employment for United States workers and improve our trade balances. Because exports are so crucial to our economy, the United States must ensure that United States businesses can compete on an equal basis in foreign markets with other producers.

Currently, United States businesses are encountering increased difficulties competing with foreign producers in overseas markets. In 1982 it was reported that exports had decreased markedly since 1981, primarily due to high interest rates and the overvalued dollar. (1982 Joint Economic Report). The export figures for 1983 are still more discouraging. From January through August, 1983, exports were down 9.4 percent from 1982 figures, while imports increased almost one percent in the same period. (U.S. Bureau of the Census, Highlights of the U.S. Exports and Import Trade, Table 1 (Report FT 990) (August 1983).)

The United States must act to improve its export trade and, thereby, its trade balances. Currently, the United States trade deficit is enormous, reaching almost $37 billion as of August, 1983. (Derived from figures in the U.S. Bureau of the Census, Highlights of the U.S. Exports and Import Trade, Tables E-2 and I-2 (Report FT 990) (August 1983).) It is predicted that our country's trade deficit may reach $40 billion by the end of 1984. This record deficit is primarily attributable to our loss of competitiveness because of the strong dollar, the recovery in domestic demand, and our low export market growth. (OECD Economic Outlook at 61-64 (July 1983).) Clearly, expansion of the United States export market is imperative.

The DISC rules have provided incentives to United States industry to expand exports from the United States. The DISC legislation became effective in 1971. Studies issued in 1982 show that during that eleven year period, United States exports, on a balance of payments basis, increased almost five fold. Although the DISC provisions were only one of many factors influencing this growth, they were nonetheless an important factor. In 1980, approximately 6.2 to 9.4 billion dollars of United States exports were attributable to DISC, an increase of about 36 percent over 1979 figures. (Treasury Department report to Congress, December 27, 1982; confirmed by an independent Price Waterhouse study, April 1982.) Until the recent recession and inflation, United States exports, as a percentage of Gross National Product, had grown ten times faster after enactment of DISC than during the preceding decade. (Data Resources, Inc., April 1981.) DISC has clearly been an important incentive for the United States export trade.

The DISC rules, however, have been contended to be an illegal subsidy under GATT. Other countries grant incentives for exports which equal or exceed those of the United States. For example, the United States taxes export income at about three-quarters of the effective rate on domestic income. Of all the countries surveyed, only West Germany arguably provides less support for exports than does the United States. Japan taxes exports at less than two-thirds of the effective rate on domestic income. The effective rate an export income in France is only one-quarter of the rate on domestic income. (Horst, National Planning Association, Income Taxation and Competitiveness in the United States, West Germany, France, the United Kingdom, and Japan, 1977.) Despite these substantial incentives for exports provided by other countries, our Administration, in an effort to satisfy our GATT trading partners, has agreed to seek a replacement for DISC which will be in compliance with GATT requirements.

The United States Council strongly recommends that any replacement of DISC be at least as supportive of United States exports as the DISC provisions have been. In this time of recovery from a recent recession, high unemployment, and continuing subsidization of foreign competition, an alternative that results in reduced exports is not acceptable.

The United States Council finds the Administration's attempts to clarify the foreign presence requirements encouraging and endorses the overall scheme. It does, however, contend that as presently drafted the foreign presence provisions of the Bill create tax and business difficulties for industry. While understanding that some foreign presence attributable to export income is necessary to satisfy GATT requirements, we suggest that further modification of these draft provisions is in order.

Pending those clarifications, the United States Council reserves final endorsement of some of the specific provisions of the Bill. These provisions are discussed in the attached technical memorandum.

There is one provision in the Bill which has no place in export legislation. Section 2(c) of the Bill provides rules intended to restrict the financing of certain trade receivables. Whatever the merits of those rules, this Bill should not be used as a vehicle for tax reform legislation. S. 1804 is designed specifically as a response to an export problem with our GATT trading partners; its provisions should be confined to that purpose.

The Council recognizes that any replacement for DISC is intended to be revenue neutral. It, however, urges you to consider authorizing a study on the impact of a Foreign Sales Corporation-type program for service industries. Such a study might be authorized under the pending Bill. In addition, the Council supports the expansion of services that qualify as "foreign trading gross receipts" under the Bill. The inclusion of foreign construction and installation services, as well as some financial and insurance services, would certainly aid in the export of United States-manufactured products.

The United States Council supports S. 1804 as it embodies what the Council believes should be the United States government's minimum commitment to export trade. The Council has carefully considered the proposed legislation, and is convinced that the Bill is basically sound and will benefit this nation's export economy. The United States Council endorses S. 1804 and urges you to support the enactment of this proposed legislation.

United States Council for International Business
Technical Comments on S. 1804

The following items require amendment or further explanation:

1. Section 921(c). -- The investment tax credit and certain other credits are denied to an FSC. Because an FSC is taxed separately, it should be entitled to the same deductions and credits as any other corporation with appropriate limitations to reflect that part of its income is exempt.

2. Section 921(d). -- Nonexempt foreign trade income of an FSC should not be sourced as domestic source income under section 921(d), thus severely restricting foreign tax credits. The source of this income should be determined under principles of Code Sections 861 through 864.

3. Section 924(d)(1)(A). -- This subsection requires that the FSC or any person acting under a contract therewith participate outside the U.S. in the solicitation, negotiation, or the making of the contract relating to the export transaction. Many taxpayers will contract with related incorporated sales subsidiaries to perform solicitation, negotiation, or the making of the contract for the FSC. If such foreign sales subsidiary (the contractee) is required to perform these functions as an agent of the FSC, the FSC would probably be subject to tax in the foreign country since the existence of a dependent agent would almost certainly be considered a "permanent establishment" in that

country. This problem can be eliminated by defining "participate" in such a way that the contractee need not be an agent of the FSC.

4. Section 924(d)(3)(A)&(B). -- These sections define total direct costs and foreign direct costs. The definition in Subsection (A) includes activities performed at any location by the FSC or any person acting under a contract with such FSC. The definition in Subsection (B) of foreign direct costs makes no reference to persons acting under a contract with such FSC. To clarify this, the "person acting under a contract with such FSC" language should be repeated in Subsection (B) or the definition in Subsection (B) should read, "total direct costs as defined in Subsection (A)."

5. Section 924(e)(3). -- This provision refers to the cost of transportation from the time of acquisition by the FSC to the delivery to the customer. Cost compilation might be affected by the terms of sale. Under CIF terms (Cost, Insurance, and Freight), the shipping charges are separately identified on the invoice and/or related documents. In this instance, it might be argued that the seller is arranging for insurance coverage and freight as agent of the purchaser since the cost of these items are passed through without markup. In contrast, under FOB terms (Free on Board), the freight charges do not appear as separate items on the invoice, and clearly such costs are borne by the seller on its own behalf. The inclusion or noninclusion of freight in the direct costs test should not be dependent upon

the formal terms of sale, since the two terms effect the same economic result. The actual freight paid by the FSC should be included irrespective of the terms of sale (CIF or FOB).

6. Section 924(g)(1)(A)(ii). -- This provision defines as excluded receipts those receipts for sales or leases of property which are for use by the United States or any instrumentality thereof. To assure that foreign military sales are not excluded, this paragraph should be clarified by providing that it does not apply to a program under which the United States purchases property for resale to a foreign government or instrumentality thereof.

7. Section 925. -- This section states the transfer pricing rules. This section should be rewritten such that the transfer pricing standard is stated to be the arm's-length price with the particular pricing rules being stated as safe haven rules within the arm's-length standard. This restatement of the transfer pricing rules will enhance the position of the U.S. as to the European GATT parties and as to the various state taxing authorities within the U.S. The state taxing authorities sometimes attempt to attribute the income of DISC's to their corporate owners on the basis that the DISC pricing rules are not arm's-length.

8. Section 925(b). -- This provision provides rules for commissions, rentals, and marginal costing. Although the same language is used as appears in the DISC legislation under §994(b), language should be included to the effect that the rules for

commissions, rentals, and marginal costing should be the same as contained in §994 and the Treasury Regulations issued thereunder as of the date of enactment of the FSC legislation.

9. Section 927(d)(1)(B). -- This section defines carrying charges, which are taxed under §921 of the FSC legislation as effectively connected income, as including any amount in excess of the price for an immediate cash sale. It is unreasonable to subject to taxation unstated interest on any terms other than a cash sale when export transactions commonly have terms of from 60 to 180 days. The §482 standard of 180 days for trade receivables should be applied in this instance so that no interest income is attributed to receivables up to 180 days.

10. Section 927(d)(2)(B). -- This section permits grouping of transactions, to the extent provided in regulations, for all purposes under FSC based on product lines or recognized industry or trade usage. The phrase "to the extent provided in regulations" should be stricken. The ability to group should not be contingent on the issuance of regulations, which may take several years, but the Treasury should be permitted to issue regulations implementing grouping, just as Treasury is permitted to issue regulations describing or implementing any other section of the Code. The basic permission to group based on product lines or recognized industry or trade usage should not be discretionary with Treasury.

11. Section 927(e)(1). -- This section relates to source rules for related persons and would appear to require parallel calculations under the DISC pricing rules. Such parallel calculations are burdensome and should not be required. The meaning of this section should in any event be clarified.

12. Section 2(b)(1) of the Bill. -- The 100 percent dividends received deduction applies only to distributions out of earnings and profits attributable to foreign trade income. This means that non-foreign trade income is taxed twice - at the FSC level and at the parent company level. Thus, the provisions act as a disincentive to an FSC that has substantial non-foreign trade income: the extreme case would be the sale of military property, in which 50 percent of gross receipts would be subject to double taxation. The easy, and fair, solution would be to tax only at the shareholder level and deem that all earnings of an FSC are distributed as of the close of a year.

13. Section 7(b) of the Bill. -- Since the proposed bill ends the tax year of existing DISC's on 12/31/83, it appears that existing DISC's will be required to satisfy the assets tests of §992(a)(1)(B) as of 12/31/83. This can be burdensome where the DISC is on a fiscal year basis and is not used to qualifying on 12/31/83, and also because it is uncertain when the law will be enacted. Since the asset qualification tests are in effect being abandoned anyway by adoption of the FSC legislation, a provision should be included expressly eliminating the asset qualification test for DISC's on 12/31/83 if the shareholder uses an FSC thereafter.

Senator DANFORTH. Mr. Gerald Howard.

STATEMENT OF GERALD HOWARD, VICE PRESIDENT, TAXES, SPERRY CORP., NEW YORK, N.Y., ON BEHALF OF THE SEMICONDUCTOR INDUSTRY ASSOCIATION, COMPUTER AND BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION, SCIENTIFIC APPARATUS MAKERS ASSOCIATION, AND AMERICAN ELECTRONICS ASSOCIATION, WASHINGTON, D.C.

Mr. G. HOWARD. Mr. Chairman, my name is Gerald K. Howard. I am vice president and tax counsel for Sperry Corp. Today I am appearing on behalf of the high technology electronics industry and its nationwide membership. Their names appear in my written statement.

The tax treatment of exports is extremely important to this industry. Twenty percent of the U.S production of this industry is exported. And the amount of the exports is increasing at the rate of 15 percent a year.

We support the foreign sales corporation provisions. However, you should be aware that this industry will not benefit from these provisions. In fact, the tax incentive that we will receive will be 10 to 15 percent less than the tax incentive that we are currently receiving under the DISC provisions.

With this unintended tax increase in mind for the high technology industry, we ask that a DISC rule that has caused us some difficulty in the past be modified or clarified, namely that the definition of software be revised—excuse me, the definition of qualified export property be revised to include software. We believe that this will assist in eliminating the uncertainty that exists in the tax law concerning software. Not only with respect to export property, but with respect to investment tax credit and depreciation.

We don't believe it was intended for the high technology industry to suffer a decrease in the tax incentives that are provided and we ask that software be included in the definition of export property. Thank you.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Gerald Howard follows:]

STATEMENT OF GERALD K. HOWARD

VICE PRESIDENT, TAX PLANNING - TAX COUNSEL

SPERRY CORPORATION

BEFORE THE SENATE FINANCE COMMITTEE

February 3, 1984

On behalf of:

American Electronics Association

Computer and Business Equipment Manufacturers Association

Scientific Apparatus Makers Association

Semiconductor Industry Association

STATEMENT OF GERALD K. HOWARD

Mr. Chairman and honorable representatives, my name is Gerald K. Howard. I am Vice President of Tax Planning and Tax Counsel for the Sperry Corporation. Sperry is a diversified high technology company in the business of developing, manufacturing and selling information processing systems and services, defense and aerospace systems, and specialized farm machinery. The markets we serve are among the largest in the world.

I am appearing today on behalf of the American Electronics Association (AEA), the Computer and Business Equipment Manufacturers Association (CBEMA), the Scientific Apparatus Makers Association (SAMA), and the Semiconductor Industry Association (SIA).

AEA is an association of high technology electronics companies representing all segments of the electronics industries. AEA has over 2,300 members nationwide. AEA companies account for 63 percent of the worldwide sales of U.S.-based electronics companies. Approximately eighty percent of AEA companies are small businesses employing fewer than 200 people; twelve percent are large companies employing more than 1,000 people.

CBEMA is an association composed of approximately 42 manufacturers of computer systems, sophisticated business equipment and other high technology electronics products.

SAMA is a national trade association representing this country's manufacturers and distributors of a wide range of scientific, industrial and medical instruments and equipment. SAMA members include 180 different companies, many of which are small or moderate in size. These companies constitute the bulk of American industry producing research, laboratory, analytical, electronic test and measurement, and process measurement and control instruments, as well as a wide range of laboratory apparatus and equipment.

SIA is the trade association of those electronics companies which manufacture integrated circuits and other semiconductor products. These products are the basic building blocks of most high technology electronics products. SIA has 56 member companies, which have well over $8 billion in sales of semiconductor products.

Exports are a major business for U.S. high technology electronics companies. According to the Department of Commerce, the electronics industry as a whole exported 11.6 percent of total U.S. merchandise exports in 1982. High technology electronics companies are among the fastest growing exporters from the United States. According to an AEA study, its members export on average about 20 percent of their total U.S. production and their production has been growing at about a 15 percent average annual rate. Because such a major portion of the U.S. production of high technology electronics products is devoted to exports, the tax treatment of exports is extremely important to this industry.

Overview: Impact of the Proposed Substitution of FSC for DISC

Over the years the current DISC provisions have been a most effective incentive for small as well as large electronics companies to begin and expand their export activities. Nonetheless, we fully appreciate the concerns of the U.S. Government's trade representatives in assuring that the U.S. tax treatment of exports does not constitute a clear violation of our trade agreements, including the General Agreement on Tariff and Trade (GATT). As a result, we encourage legislative efforts to revise the current DISC provisions in order to meet our trade requirements without increasing the general level of income taxation applied to export activities. Based on this view, we support the proposal to replace DISC with Foreign Sales Corporations (FSCs), along the lines described in S. 1804.

We support the legislation even though it contains one major disadvantage for high technology electronics companies: the abandonment of the incremental computation of benefits as provided under DISC in favor of a flat percentage of combined taxable income measurement of benefits causes a significant tax increase on the export activities of most electronics companies. Under the FSC proposal, qualifying taxpayers will generally be permitted to treat as exempt from U.S. tax 17 percent of their combined taxable income attributable to exports. However, most electronics companies have consistently received DISC benefits on a larger percentage of their combined taxable income. Although no definitive data exists for the industry as a whole, a recent survey of twenty medium and large electronics companies (which include six of our country's fifty largest exporters) indicates that the percentage of combined income of high technology electronics companies eligible for DISC benefits is close to 20 percent, rather than the 17 percent permitted under the FSC proposal.

This relatively high level of benefits received by high technology electronics companies under DISC is attributable primarily to the fact that the level of exports of these companies has been growing rapidly, and the computation of DISC benefits on an incremental basis provides a relatively larger incentive for growing companies. We recognize that any shift in export taxation rules, such as the FSC proposal, which limits U.S. taxation based on foreign economic activity, cannot likely be computed on an incremental basis. Thus, we do not ask that

S. 1804 be modified in this respect. However, if electronics companies generally are required to face a tax increase as part of any process of replacing in a revenue neutral manner the current DISC provisions with the provisions of S. 1804, we do ask that a few of the DISC rules which have caused significant problems for electronics companies be modified to make the FSC provisions more workable as applied to these companies. In particular, we recommend that changes be included relating to the treatment of software and the so-called foreign content rule. We also are concerned about various technical problems relating to the specific provisions of S. 1804. Finally, we believe that, perhaps at a later date, further and more fundamental changes in the treatment of export income in particular -- and foreign income in general -- should be considered by this Committee.

Changes in the Treatment of Software

Computer software is the end product of what is perhaps the world's fastest-growing industry. The significance of this industry to the U.S. balance of payments and the U.S. job market cannot be over-estimated. The importance of computer software as an industry is reflected in the following figures showing worldwide software sales and income revenues for 1983 and amounts projected for 1988:

	Revenues (in millions of $)		Percentage Increase
	1983	1988	
Vendor Software (mainly by computer manufacturers)	6,704	23,932	357
Independent Software Companies	8,361	34,868	417
TOTALS	15,065	58,800	390

Source: IDC, Market Industry Research

In spite of its significance to the U.S. and world economy, the legal and tax treatment of computer software is today in a state of limbo from a number of points of view. For example, presently software owners or developers have little assurance that they will be able to eventually protect their rights to software since various international legal conventions (*e.g.*, copyright law, patent law, trademark law, etc.) all seem inadequate for this purpose. Further, the status of software for many U.S. tax purposes, including the investment tax credit and ACRS, is uncertain. In a similar manner the eligibility of software under current DISC provisions (and the proposed FSC provisions of S. 1804) is often unclear. Software which is "bundled" with hardware (*i.e.*, where software and hardware are sold together for a single price) is likely eligible for DISC benefits under present law, and FSC benefits under S. 1804. However, if a separately stated price exists for the software, or if software is sold to a customer in a separate transaction, eligibility for DISC (or FSC) benefits is uncertain -- even where the software is an integral part of a computer system exported by the same taxpayer. In such cases no valid reason exists for allowing any ambiguity as to whether the transfer of rights to use computer software qualifies as "export property" for purposes of the Foreign Sales Corporation Act.

Other countries are already addressing questions relating to the tax and legal treatment of software and in doing so are positioning their companies to obtain a large and growing share of the software market. For example, the EEC-sponsored ESPRIT (European Strategic Program for Research and Information Technology), while scrupulously avoiding protectionist rhetoric, nevertheless offers European Community support to companies in this industry in targeted areas. Also, Japan is presently focusing on the computer industry and particularly on software development and is offering grants, incentives, and special educational programs to develop a technological edge in this area.

In Europe, treatment of software for value added tax purposes has not yet clearly been resolved. However, several

EEC countries (e.g., the Federal Republic of Germany, France, and Belgium) take the position that the sale or licensing of software is a taxable transaction subject to VAT at the consumer level. Thus, to the extent that the absence of VAT on exported property constitutes an indirect export incentive for these European countries, software exported from Europe benefits from this incentive to the same extent as does other eligible property. We should now begin to counterbalance this effect.

We do not believe that the fact that computer software is frequently licensed (rather than sold outright) to customers should have any particular significance in determining the eligibility of software for FSC benefits. Licensing is merely one of many devices used in an attempt to protect the proprietary interest of the software developed in the absence of a suitable legal convention to accomplish this result. The key question then is: Does the right to use software (either through ownership or through license) constitute a property right? If so, there is no valid reason for discriminating against this property (and the industry which produces it) in establishing the tax treatment of exports.

We urge that the language of S. 1804 or the accompanying legislative history clearly specify that computer software exported from the United States qualifies as "export property."

Foreign Content Rule

Present DISC rules, proposed in most instances to be carried forth in the FSC legislation, specify that a product is eligible for DISC benefits only if 50 percent of the fair market value of the product is attributable to manufacturing activity within the United States. Under these DISC rules companies which initially manufacture products in the United States, ship the products abroad for further manufacturing and then reship them back to the United States for final manufacturing and sale can be denied DISC treatment upon the ultimate export of the products for final sale and use outside of the United States. This result occurs even though 50 percent of the value of the products when finally exported is in fact attributable to U.S. manufacturing activity. The cause of this result is a rule in IRS regulations (reflecting the legislative history of the 1971 Act which created DISC) which measures the foreign content of any product by its total value when it is reshipped to the United States after foreign manufacturing rather than by the added value attributable to the foreign manufacturing after the initial U.S. manufacturing. In effect, the initial U.S. manufacturing activity is treated as foreign rather than U.S. manufacturing activity. We urge that, as part of its consideration of FSC legislation, Congress specify in the legislative history that the general foreign content rule be interpreted so that all U.S. manufacturing activity is treated as giving rise to U.S. content for purposes of the 50 percent requirement.

Related Technical Issues

As presently drafted, the proposed FSC legislation raises technical issues that need to be clarified in the bill or its legislative history. We understand that most of these issues have been covered in the Administration's Technical Explanation to the bill. We hope to comment on the Technical Explanation once we have had a chance to review it. However, there are several areas of particular importance that merit discussion at this time and may not be covered in the Technical Explanation.

1. Commission FSC

The proposed legislation is written in terms of a buy/sell FSC rather than in terms of a commission FSC. The Secretary is authorized to prescribe regulations "as may be necessary" for the treatment of a commission FSC.

It is our experience and understanding that most DISCs are commission DISCs, not buy/sell DISCs, and that most taxpayers would wish to establish commission FSCs once this legislation is enacted. Therefore, the basic rules applicable to a commission FSC should be contained in the legislation, rather than being left exclusively to regulations.

2. Letter of Credit Transactions

The proposed legislation requires that certain economic processes take place outside the United States by or on behalf of the FSC. One such activity is the assumption of credit risk. In actual practice, a seller's credit risk may be reduced (but not eliminated) if the buyer obtains a letter of credit from an acceptable bank. Letters of credit are also used to comply with foreign exchange controls of other countries and as a means of facilitating transactions in the absence of adequate credit information from foreign countries. Since a seller retains some risk even when a buyer obtains a letter of credit, the FSC legislative history should indicate that the assumption of risk requirement can be met even when the transaction is covered by a letter of credit.

3. Investment Income

The proposed legislation recognizes that a FSC, as a separate legal entity, may earn investment income. This income is treated as U.S. source income that is effectively connected with a permanent establishment within the United

States. Accordingly, the FSC is subject to current U.S. taxation on any investment income it earns. However, since the proposed legislation provides a dividends-received deduction only for distributions of earnings from foreign trading income, investment income is taxed a second time by the United States when it is repatriated. Since the FSC is subject to U.S. taxation on investment income when it is earned, there is no reason to deny its parent a dividends-received deduction when it is repatriated.

Long-Run Tax Policy Changes

The necessity of considering FSC proposals at this time relates to the requirements of our trade agreements. However, at a later date the electronics industry believes a broader reexamination of the tax treatment of export income, and the tax treatment of foreign income more generally, is in order. The current DISC provisions (and, with the changes described above, the proposed FSC provisions) do provide an appropriate framework for the taxation of U.S. exports. However, at the same time existing law Subpart F provisions provide countervailing *disincentives* for U.S. exports because under Subpart F income earned by foreign affiliates from resale abroad of U.S. exported products is often subject to current U.S. tax. Examining the continuing rationale behind these provisions and considering their modification or elimination should be made a long-run priority by this Committee.

Indeed, an examination of Subpart F as it applies to export transactions could be made in the context of a consideration of the broader issues of the application of Subpart F to all sales transactions and to many other intercompany transactions. The Subpart F provisions were first established in the early 1960's, when U.S. companies dominated many international markets. As applied to current economic competitive conditions, however, the provisions make it more difficult for U.S. companies to remain competitive and expand their operations. A thorough reexamination of these provisions should be undertaken over the long run.

Conclusion

We strongly support the FSC proposal contained in S. 1804 as a replacement for the current DISC provisions. We reach this conclusion even though the shift from DISC to FSC will significantly reduce the overall level of tax benefits received by high technology electronics companies on export transactions. However, while the FSC legislation is being considered we believe that issues relating to the eligibility of software and the foreign content rule should be clarified in a manner which would make the FSC provisions more workable as applied to high technology electronics companies.

Senator DANFORTH. Mr. Reed.

STATEMENT OF ROBERT REED, VICE PRESIDENT, FINANCE, INTEL CORP., SANTA CLARA, CALIF., ON BEHALF OF HIGH TECHNOLOGY FSC COALITION

Mr. REED. Thank you, Senator.

My name is Robert Reed. I am vice president of finance for Intel Corp., a leading manufacturer of semiconductors. Of our 1983 revenue of $1.1 billion, over 30 percent was export sales. I am testifying today on behalf of High Technology FSC Coalition.

FSC and DISC tax provisions are designed to stimulate U.S. exports and to provide investment and job creation in the U.S. They work, and in particular, they work for the high technology industry. At a time when foreign countries are offering high technology firms substantial financial inducements to take our best jobs abroad, DISC stands as one of the few financial incentives to expand within the U.S. There are serious challenges to the U.S. high technology industry in maintaining international competitiveness.

Huge investments are required for R&D and increasingly complex and costly capital equipment. Foreign competition is benefiting from targeted measures of their governments, specifically designed to subsidize high technolgy development. For the U.S. industry to remain competitive and grow, both industry and Government must respond to this foreign challenge. Industry will continue to invest in R&D and capital while Government provides an environment where we can compete effectively.

DISC is a step in the right direction. Thank you.

Senator DANFORTH. Gentlemen, thank you very much.

[The prepared statement of Robert Reed follows:]

STATEMENT OF ROBERT REED, VICE PRESIDENT, INTEL CORP., ON BEHALF OF THE HIGH TECHNOLOGY FSC COALITION

Mr. Chairman, my name is Robert Reed. I am Vice President for Finance of Intel Corporation, headquartered in Santa Clara, California. Intel is a merchant semiconductor manufacturing company with 1983 sales of $ 1.1 billion.

I am testifying before you today on behalf of the High Technology FSC Coalition, a newly-formed coalition of companies whose objective is to draw attention to the importance of the DISC/FSC tax measures for America's high technology industries. (A list of member companies is attached.) I am accompanied by Michael Gadbaw of Verner, Liipfert, Bernhard and McPherson, who is serving as counsel to our coalition. The message we bring to your Committee, Mr. Chairman, is that enactment of the Foreign Sales Corporation tax measures, as a replacement for the current DISC provisions, is critical to the future competitiveness of the semiconductor and computer companies that are at the heart of the U.S. high technology, industrial sector.

I would like to illustrate this point with some data taken from the 1981 DISC Report. According to the Department of Treasury, in 1980, high technology firms accounted for nearly 37 percent of reporting DISCs, and for 37 percent of DISC receipts. Furthermore, high technology companies earned over 56 percent of DISC income in 1980, and accounted for 55 percent of tax-deferred income.

What these data show is a little known and insufficiently appreciated fact, namely, that the DISC is one of the few tax provisions that reduce or mitigate the already disproportionately high effective tax rate applicable to high technology companies. Without the DISC, U.S. high technology companies would be further disadvantaged, because they are heavily invested in relatively short-lived equipment while U.S. tax policy rewards those with long-lived equipment. A November 1983 study by the staff of the Joint Committee on Taxation showed that the average U.S. tax on U.S. income for computer and office equipment manufacturers for 1980-1982 was 25.6 percent, while that for instrument manufacturers was 28.6 percent. Both tax rates were well above the average for all U.S. companies. See also, High Technology Tax Policies for the 1980's; A Report of the Ad Hoc Electronics Tax Group, January 1984.

To understand why high technology companies have such a major stake in the future of the DISC -- and the proposals to replace it with a FSC -- I would like to take a few moments to talk about international competition in high technology and the international competitive challenges we face.

International Competitiveness In High Technology

The importance of international competitiveness in electronics has been well stated in a recent report of the Office of Technology Assessment:

> 4. The United States can continue to be highly competitive in electronics and other technologically driven industries, with U.S. firms remaining leaders in innovation, in international trade, and in sales and profits at home and abroad. Not only is this possible, it is necessary if the United States is to maintain its standard of living, its military security, and if the U.S. economy is to provide well-paying and satisfying jobs for the Nation's labor force. Electronics is

> indispensible to a broad range of manufacturing and service functions, from computer-aided design or the structures of office buildings to the switching of the telephones within those buildings. Office of Technology Assessment, International Competitiveness in Electronics, November, 1983.

U.S. high technology companies are doing all they can to meet the competitive challenges they face. The companies in our coalition are typical of the industry in that their levels of research and development substantially exceed all industry averages with R & D as a percent of sales as high as 20%. Moreover, they generally pay little or no dividends but rather reinvest their profits in R & D and capital equipment. At the same time these companies face increasing demands for capital to finance research and development and to pay for ever more complex and expensive manufacturing equipment. Finally, U.S. high technology industries pay high effective tax rates (relative to other manufacturing industries).

High technology companies benefit from DISC provisions because they are growing rapidly and they are heavily oriented toward exports. In the semiconductor industry, for example, the typical company exports over 30% of its sales. High technology companies generally export a far high percentage of their U.S. production than does the average U.S. manufacturer. The DISC provisions offset the competitive advantage which other countries provide their exporters through such practices as the rebate of indirect taxes and flexible arms-length pricing rules. For high technology companies, the disadvantage inherent in this situation is compounded by the variety of other measures which foreign countries use to promote their domestic high technology industries.

The dilemma facing the U.S. industry is that the international competitive balance may be tipped in favor of foreign competitors, not by any lack of effort on the part of U.S. companies, but by the actions of foreign governments in support of their own industries and the lack of focus of the U.S. Government on the impact of its own policies on its high technology industries.

Foreign Government Targeting

All major trade competitors of the United States have in place policies designed to increase the international competitiveness of their industries in particular export sectors. Foreign governments have, virtually without exception, focused those targeting policies on their high technology industries. Those policies, and the adverse consequences they have in terms of the domestic and foreign market share of U.S. high tech industries, are by now well-known.

The Japanese Government's coordinated use of R&D subsidization, government loans, tax relief, preferential procurement and market protection in an effort to surpass the U.S. computer and semiconductor industries is a major case in point. The Japanese effort was focused on achieving superiority in VLSI, which is critical for the development of computers and telecommunication equipment. The French government has used similar measures to promote its computer and telecommunications industries. In addition, six industries, including electronics, machine tools and biotechnology have been targeted as essential export sectors through preferential government procurement and credit. Germany, too, has focused its industrial policies on high tech industries, and provides currently the highest level of government support for R&D in the West, supplemented by preferential procurement and credit. Newly developing countries are, increasingly, implementing similar programs. The targeting policies implemented by foreign governments continue to create an advantage for foreign high tech industries in competition for export markets.

As part of, or supplemental to, their targeting measures, foreign governments have structured their taxation systems in ways aimed at improving the export performance of their industries. Analysis of such foreign tax measures reveal that other countries promote exports through tax measures to a greater extent than does the United States. Japanese corporations are, for example, able to avoid taxation on a foreign subsidiary's income as well as on dividends paid to the parent corporation, while at the same time benefitting from a deduction for developing overseas markets. Both French and German corporations are able to retain untaxed the foreign source income of their foreign subsidiaries, while distributing to shareholders domestic profit dividends that bear tax credits. In the Netherlands and in Sweden, net losses from foreign branches are deductible, even though income from those branches is not taxed. U.K. corporations are able to accumulate untaxed profits overseas, and benefit from foreign tax credits, even if the foreign taxes in question are not paid.

The American Response

The response of the U.S. Government to foreign government targeting should not be to emulate the efforts of our trading partners. As the Office of Technology Assessment has pointed out, "there is no one thing the Federal Government can do that will make a big difference for the future competitiveness of the U.S. electronics industry, but there are many specific policy concerns that deserve attention." One of those concerns should be the future of the DISC provisions.

The DISC has, to date, served as an important means of offsetting in part the export advantages that foreign high technology industries enjoy as a result of foreign targeting practices. The DISC has served as a needed incentive for expansion of U.S. exports, and as an important benefit to all exporters. Because of the rapid growth and the export orientation of high tech industries, the DISC -- especially the computation of DISC benefits on an incremental basis -- has been of particular benefit to those industries. For those industries considered "high technology" in the Treasury's most recent DISC report, the ratio of DISC receipts to total receipts of the corresponding U.S. manufacturing industry [*] was more than three times that for other U.S. manufacturers.

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[*] Derived from the 1980 IRS Sourcebook of Statistics of Income, Corporations.

In order that U.S. high technology companies are able to continue to compete against their targeted foreign competitors, it is essential that they continue to benefit from tax provisions that assist and reward export sales to at least the same extent as does the DISC. Any legislative substitute for the DISC must be carefully tailored in a way that protects the vital concerns of its predominant beneficiary -- U.S. high tech companies -- and in a way that maintains the existing balance of benefits to those companies.

The proposed Foreign Sales Corporation would substantially increase the effective tax rate for most high tech companies. Under the FSC, a maximum of 17 percent of taxable income attributable to export sales would be tax-exempt. Most high tech companies benefit currently from tax deferral on a significantly higher percentage of their income. However, the tax increase under the proposed FSC can, and should, be compensated for by other changes in the tax structure.

In particular, the FSC should include language clarifying that computer software qualifies as "export property" for purposes of the Act. Despite the importance of software to revenue and employment in the U.S. high tech industries, and despite its substantial contribution to the U.S. balance of payments, the tax treatment of software is currently unclear. Other countries have recognized the importance of their software industries and are using export incentives and other means to promote them. The FSC offers a needed mechanism for counteracting the advantages accruing to U.S. competitors in this area.

The FSC should, in addition, designate as U.S. content all content attributable to manufacturing activity within the United States. U.S. companies are disadvantaged under the DISC when they send goods abroad for further processing, reimport them, and then export the finished product. Currently, the total value of the product when reimported into the United States is considered foreign content. This inequity should be eliminated under the new law.

Finally, the FSC must be structured to accommodate the need of small companies. The U.S. electronics industry in particular is characterized by a large number of young, dynamic companies that rely to a significant extent on export sales. It is critical to the continued vitality of such companies that new legislation in no way diminish their incentive to expand export sales.

HIGH TECHNOLOGY FSC COALITION

Advanced Micro Devices

Control Data Corporation

Data General Corporation

Digital Equipment Corporation

Hewlett-Packard Corporation

Intel Corporation

NCR Corporation

Sperry Corporation

Senator **Danforth**. You heard Secretary Pearlman's testimony with respect to Treasury's position on expanding this legislation, particularly to cover services, but I guess the same would apply to software.

Treasury is very good at coming forth with estimates of the revenue impact of changes in the tax law. Their general position is: Don't give up any dollars, and that is the big fight around here—the deficit, as you know. It has a major effect on trade, and we are all trying to keep the deficit down. I am sure it is much more difficult to quantify the effect of changing the law and improving sales, generating business for American companies, but it would certainly be helpful if one were considering the bill to have some notion as to what the effect would be of including services and including software.

Is there any way to get a handle on that? Any way to come up with guesses or numbers as to what the effect would be on sales abroad?

Mr. G. **Howard**. Mr. Chairman, the anticipated revenue from software with the high technology industry is anticipated to grow by 390 percent over the next 5 years. And I think the only way that we can assure that that increase will actually take place is to provide some incentive for the development of the software and also for the export of the software.

Senator **Danforth**. Do you, Mr. Howard, have an opinion?

Mr. F. **Howard**. We have sent out a questionnaire memorandum to our membership asking them for specific examples of how the extension of DISC or FSC or services would improve their exports. I hope, on the basis of that information, as economists may be able to massage it, we can demonstrate that there will not be any revenue loss by such extensions.

Senator **Danforth**. If you can come up with anything, we would certainly like to hear from you. I would guess that it is the case that, while services and high tech exports are increasingly important to the American economy, they are also increasingly competitive, and targeted by our trading partners oftentimes for their major growth areas. Your feeling is that, if other countries are going to be emphasizing this important area, the United States has to keep up with them. Thank you very much.

Senator Chafee.

Senator **Chafee**. Thank you, Mr. Chairman.

Let me ask Mr. Howard and Mr. Reed. Obviously, as you know from my questions earlier, I am interested in this area. At the same time, we know we are in a financial bind in the country when we are spending $200 billion more than we take in, with no end in sight. So, to do anything that is not revenue neutral—as the term goes—is difficult. It's not only difficult, it's not helpful for the country. Unless the payoff on the other end is really substantial. Now, my question to you is, How really important do you view this measure—your proposal—vis-a-vis, let's say, extending the R&D tax credit? We have heard from the AEI before, and their testimony clearly indicated that the No. 1 item on their legislative agenda was the extension of the R&D tax credit. Is that right?

I know what they said. Do you reflect that?

Mr. G. **Howard**. Yes, I do.

Senator **Chafee**. I am putting you on the spot, but we have really got to know. You come up and testify that you are for it, but how high is it on your worry list?

I am talking about the FSC.

Mr. G. **Howard**. The FSC is extremely important to the——

Senator **Chafee**. Yes, I realize that the FSC is, but now let's get to the extension of the R&D credits as compared to an inclusion of software in the FSC.

Mr. G. **Howard**. We feel that there needs to be an incentive in the United States to not only spur the development of software but to give the high technology group an incentive to export it, rather than maybe go abroad to develop that software.

Senator **Chafee**. I suppose one of the answers is that you are doing pretty well so far, aren't you?

Mr. G. **Howard**. Yes. There is no doubt that the United States as far as the development of software is the leader. But, obviously, we have to maintain that lead, and the competition is getting more difficult and difficult, especially over the last 2 years, we have noticed, in Europe, and not only in Japan.

Senator **Chafee**. What do you say about that?

Mr. **Heyde**. Our primary mission is simply to enact S. 1804 as it is. We do support the extension of the provisions to software and to other services, but we realize that this is a fairly complicated question as to the extent that services should be covered and we are not sure that we can do the spadework in time to put this bill into the tax bill. Consequently, we would like to see S. 1804 enacted as it is or with amendments that will be somewhat substantially noncontroversial as to coverage, and enact S. 1804, and then look very closely at services.

Senator **Chafee**. Thank you very much.

Senator **Danforth**. Senator Dole.

Senator **Dole**. No, I have no comments. I think Senator Chafee has touched on it. If we could moderate the strength of the dollar, that would probably help you more than all these tax subsidies—they are called incentives in the statements—but they are, in effect, subsidies. We would like to figure out how to do that. One way to do that is to reduce the deficit, not to expand it, and I don't know. You don't have any estimates including services, right? Cost estimates? You probably said it would generate money.

Mr. F. HOWARD. One study has been done by assistant professor of economics, Robert Frenstra, at Columbia, and his estimate that expanding DISC include services would generate an additional $300 to $600 million in exports. And that does not take into account the additional merchandise exports that would be generated by the increased service exports. His cost estimate is in the area of $60 million, but that assumes that it would have an immediate jump into DISC by all the service industries. I think it is going to take some time for the service industries to set up their DISC.

Senator DOLE. I think as we massage this a little bit that we might be able to rearrange the priorities a little—we never know what might happen.

Senator DANFORTH. Gentlemen, thank you very much.

Mr. Aus, Mr. Overton, Mr. Scott, and Mr. Baldwin.

STATEMENT OF ROBERT AUS, PRESIDENT, ARMCO INTERNATIONAL SALES, WASHINGTON, D.C.

Mr. AUS. Mr. Chairman, my name is Robert M. Aus, and I am president of Armco International Sales, a division of Armco, Inc. The primary responsibility of the division is exporting products of domestic Armco divisions. We thank you for the opportunity to appear before this committee.

Armco is actively engaged in export sales, since 1911, and presently exports products such as specialty steels and fabricated machinery to more than 80 countries routinely.

Under the DISC legislation, our exports have grown approximately 15 percent per year until a substantial decline occurred last year. Armco supports the FSC proposal as a viable DISC alternative with the exception of the elimination of export receivable financing income from the tax exempt classification. Trade financing is an integral part of such export business. The Federal Government has recognized this requirement through various trade financing programs of Eximbank.

Most recently, the Eximbank has emphasized its trade financing support for small export businesses as required by the ETC Act of 1982. Trade financing requirements stem from liquidity problems in developing countries below market subsidized rates provided by foreign governments, exposure to maxi devaluations in LDC's, long lead-times for capital projects and normal competitive factors. DISC benefits are considered by Armco when product price financing packages are put together. In fact, our export operating division operates at break-even or less without the DISC benefits. Substantial incremental business has been developed due to DISC benefits.

In conclusion, Armco and many smaller exporters would suffer a decline in incremental sales if partially tax exempt export trade financing is eliminated. It has been argued that the FSC proposal as presented is revenue neutral. Armco contends, however, that the failure to promote export trade financing will have a negative revenue impact and contribute to the growing trade deficit that reached a record $66 billion last year.

For these reasons, we implore the committee to provide in the proposed FSC legislation a tax incentive for export trade financing equivalent to that provided by the DISC law. Thank you.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Robert M. Aus follows:]

STATEMENT
ON
S. 1804--FOREIGN SALES CORP. ACT
BEFORE THE
SENATE FINANCE COMMITTEE
BY
ROBERT M. AUS
PRESIDENT-ARMCO INTERNATIONAL SALES
ARMCO INC.
FEBRUARY 3, 1984

Mr. Chairman, my name is Robert M. Aus. I am President of Armco International Sales, a division of Armco Inc. The primary responsibility of the division is exporting products of domestic Armco divisions. We thank you for the opportunity to appear before this committee.

Armco has actively engaged in export sales since 1911 and presently exports products such as specialty steels, fabricated steel products, oil field equipment and other specialty products to more than 80 countries routinely. Under the DISC legislation our exports have grown approximately 15% per year until a substantial decline occurred in 1983.

Armco supports the FSC proposal as a viable DISC alternative with the exception of the elimination of export receivable financing income from the tax-exempt classification.

Primary reasons for this objection are:

- Trade financing is an integral part of much export business. (The federal government has already recognized this requirement through various trade financing programs of the EXIM Bank. Most recently the EXIM Bank has emphasized its trade financing support for small export businesses as required by the Export Trading Company Act. Subsequent congressional action has provided 2.7 billion dollars for small businesses.)
- U. S. businesses must be competitive not only in price, quality and delivery but also must be competitive in the trade finance area.

Armco's export business is mainly in the capital goods market. The nature of this market is:

- Price sensitive due to strong competition from Western Europe, Japan and Canada.
- Most industrialized countries provide export financing programs below world market rates.
- Capital goods are often incorporated into large projects such as dams, buildings, oil rigs, etc., with long lead times before pay back. This creates a demand for financing.
- Developing countries lack liquidity in hard currencies, necessitating longer repayment terms.
- Capital goods require direct sales rather than reselling through related foreign corporations. This is also characteristic of small exporters.

- Exposure to maxi-devaluations in LDC's and resultant rescheduling of obligations.

Due to the nature of Armco's export activity, Armco has restructured its export operation to achieve efficiency and utilize the benefits of trade financing provided by the current DISC law. DISC benefits are considered when product price/financing packages are put together. In fact, our division operates at breakeven or less without the DISC benefit. Substantial incremental business has been developed due to DISC benefits.

Mr. Chairman, this Committee and the Administration have consistently emphasized that any DISC substitute should not only be admissible under the GATT but also provide equivalent benefits and incentives for U. S. exporters as the existing DISC legislation. S. 1804 in its present form does not meet this test.

In conclusion, Armco and many smaller exporters would suffer a decline in incremental sales if partially tax-exempt export trade financing is eliminated.

It has been argued that the FSC proposal as presented is revenue neutral. Armco contends, however, that the failure to promote export trade financing will have a negative revenue impact.

For these reasons, we implore the committee to provide in the proposed FSC legislation, a tax incentive for export trade financing equivalent to that provided by the DISC law.

Senator **Danforth**. Mr. Overton.

STATEMENT OF RICHARD A. OVERTON, DIRECTOR OF CORPORATE TAXES, MONSANTO CO., ST. LOUIS, MO.

Mr. **Overton**. Yes, sir, my name is Dick Overton, and I am the director of the corporate tax department for Monsanto Co.

Monsanto Co. strongly supports Senate bill 1804. Monsanto is a major multinational chemical company, headquartered in St. Louis, Mo. In 1982, Monsanto had about $900 million of export sales representing about 18 percent of its total U.S. sales. Monsanto export business provides approximately 6,500 U.S. jobs. Monsanto believes that business needs an export tax incentive. Monsanto's experience is that the DISC impacts export sales principally in two ways.

First, plant locations. For example, the DISC benefit was a significant factor in Monsanto's decision to locate a large agricultural chemical plant in Fayetteville, N.C. This benefited both the United States and Monsanto since it resulted in a multimillion dollar investment in the United States, creating approximately 150 permanent jobs.

It also significantly increased the Federal revenue, even after taking the DISC benefit into account. And, finally, it substantially increased local taxes. The second way that we find DISC is helpful is in sourcing decisions. Monsanto has plants both in the United States and abroad capable of producing the same products. The DISC benefit encourages managers to source from the United States.

Monsanto believes that the administration's FSC proposal is sound. The use of a foreign corporation would result in some disruption and added cost and increased complexities. However, it is believed that these problems are manageable. Monsanto has previously submitted technical comments to Treasury, and we would hope that any final legislation would take our comments into consideration.

In conclusion, Monsanto believes that an export tax incentive is essential, that DISC has been effective, and Monsanto believes the replacement proposal will also be effective. Monsanto is a strong supporter of this legislation.

Senator **Danforth**. Thank you, sir.

[The prepared statement of Richard A. Overton follows:]

STATEMENT OF MONSANTO COMPANY'S POSITION
BY DICK OVERTON BEFORE THE SENATE
FINANCE COMMITTEE ON SENATE BILL 1804

Tax Department for Monsanto Company.

I am appearing to testify in support of S. 1084, which would replace the present export tax incentive known as a Domestic International Sales Corporation with a new provision calling for the creation of a "Foreign Sales Corporation." Monsanto strongly supports S. 1804. Monsanto Company does have reservations about certain provisions of the bill and has expressed those concerns to the Treasury in a letter dated October 26, 1983, a copy of which is attached.

Monsanto Company is a major multinational chemical company headquartered in St. Louis, Missouri. Monsanto has investments in 166 manufacturing plants, laboratories, and technical centers in 20 nations employing 52,000 people. Monsanto maintains sales offices or sales agents in 65 foreign countries selling more than 1,000 products in 100 countries. These include chemical, agricultural, plastic, man-made fiber, and electronics products. Monsanto is a major exporting company, and in 1982 had approximately $900 million of export sales, representing 18% of Monsanto's total United States sales.

The U.S. currently suffers from a substantial trade deficit. Maintaining and increasing U.S. exports is vitally necessary to reduce the trade deficit. In addition, U. S. exports are vitally necessary to preserve and increase the number of U.S. jobs. It is Monsanto's view that business needs an export tax incentive. While it is true that the level of export sales is influenced by a number of factors, including a strong dollar, we believe that DISC has increased the level of export sales. This is borne out in the most recent Treasury Department report on DISC, which indicates that DISC increased exports in fiscal 1981 by $7 billion to $11 billion. In addition, the recent study by Price Waterhouse concludes that the DISC tax incentive has increased U.S. exports between $1.5 billion and $7 billion, and further concludes that DISC actually returns $1.24 to the U.S. Treasury for each dollar of tax incentive provided. Monsanto agrees with the studies of DISC's effect. While Monsanto cannot evaluate these studies of all U.S. exporters in detail, Monsanto can describe the effect of DISC on Monsanto. DISC has clearly increased Monsanto's export sales.

One reason DISC has increased Monsanto's exports is that the benefit is reflected in the Monsanto management accounting system in each unit manager's yearly operating results on which the manager's performance is evaluated. This ensures that the DISC benefits are properly considered in management decisions.

These management decisions can impact the level of export sales in three ways:

1. Plant Location Decisions

When Monsanto is deciding where a plant should be located, the DISC benefit is taken into account. The DISC benefit is a significant item in making U.S. plant sites more desirable than foreign plant sites. The DISC benefit was a significant positive factor in Monsanto's decision to locate a large agricultural chemical plant, for which 80% of the production was for export, in the United States, Fayetteville, North Carolina, rather than a foreign location. Several overseas locations, including Puerto Rico and Belgium, were seriously considered over an extended period. As a result of this decision, both the U.S. and Monsanto benefited significantly in the following ways:

- A new multimillion dollar investment was made in the United States, creating construction jobs and approximately 150 permanent jobs.
- Federal tax revenues were increased by many millions each year by the sales of the goods manufactured in the plant, even after taking the DISC benefits into account.
- Local property taxes were increased by an estimated $500,000 annually, and North Carolina state income taxes will be increased substantially over a long period.

2. Sourcing Decisions

Monsanto has plants capable of making the same product in the U.S. and abroad for a number of its products. The sourcing of foreign markets from U.S. versus foreign plants is a real planning option for Monsanto managers. The DISC benefit is important in encouraging managers to source from U.S. plants.

3. Whether a Product of Marginal Profitability Will Be Exported at All

In some cases the DISC tax benefit can mean the difference between a product of low profitability being exported at all. In depressed market conditions, selling prices are sometimes so low that a producer cannot recover even the out-of-pocket expenses. Without the tax incentive, these sales would normally not occur. Such sales help keep U.S. jobs and reduce the balance of trade deficit.

From 1971 through 1982 Monsanto increased its export sales by 565%, which is approximately 400% greater than the rate of increase of our domestic sales. While it is difficult to measure the number of U.S. jobs created by our export business, one reasonable method would be to base the number of export jobs on the ratio of U.S. sales as compared with export sales. On this basis, Monsanto's export jobs increased 93% since 1971 for a total of approximately 6,500 export jobs in 1982.

Monsanto has related the above to indicate the importance of the DISC tax benefit to Monsanto's export business. Our interest in the proposed FSC legislation is based primarily on our belief that an export tax incentive comparable to DISC is very important in maintaining and expanding American export business, thereby reducing the trade deficit and keeping and increasing U.S. jobs.

Monsanto supports and commends the Administration in its effort to provide an export tax incentive which is acceptable under the General Agreement on Tariffs and Trade (GATT) and which produces roughly the same tax benefit as DISC. We accept the Administration's position as to the legal problems of DISC under GATT to the effect that some change in DISC is necessary. Monsanto believes that the Administration's FSC proposal is generally sound. The use of a foreign corporation would result in some disruption, added cost and increased complexities in the operation of Monsanto's export business; however, it is currently believed these are manageable.

Monsanto has some specific concerns with the proposed legislation which we hope you will consider.

1. Foreign Economic Presence

   The proposed legislation requires that certain economic processes take place outside the U.S. While this may be necessary to comply with GATT rules, it is very important that the new legislation not require exporters to move U.S. personnel to foreign locations. Such moving of U.S. personnel effects reduction of U.S. jobs, which defeats one of the major purposes of the legislation which is to increase U.S. jobs. Monsanto believes carefully drafted contractual arrangements should provide the needed substance without requiring the relocation of jobs.

2. Agent Status of Contracting Service Provider

The proposed law provides that the FSC, or any person acting under a contract with the FSC, must participate outside the U.S. in the solicitation, negotiation, or the making of the contract relating to the export transaction. The question is whether a person contracting to perform these functions for the FSC must be an agent of the FSC, or whether a supplier/ distributor contractual relationship will be sufficient. If the contracting party must be an agent, this will probably subject the FSC to foreign tax. The foreign tax will often produce a total tax burden greater than the normal U.S. tax rate of 46% and thus defeat the purpose of the FSC export incentive. The contracting party should not be required to be an agent of the FSC. This should be clarified in the law.

3. Computation of Taxable Income

The computation of taxable income of the FSC and the related supplier should be the same as under the DISC legislation. This is important to prevent disruption and confusion and also to preserve the validity of the Administration's revenue estimates. The Administration's proposal appears to do this, but the language should be clarified by express reference to the existing rules.

In conclusion, Monsanto believes an export tax incentive is essential to U.S. exports resulting in the decrease of the trade deficit and the maintenance of U.S. jobs. DISC has been effective in contributing to these goals. Monsanto believes the FSC proposal will also be effective in contributing to these goals and, subject to the concerns mentioned above and in our detailed techical comments, the FSC proposal should be enacted into law.

Monsanto

TAX DEPARTMENT

Monsanto Company
800 N. Lindbergh Boulevard
St. Louis, Missouri 63166
Phone: (314) 694-1000

October 26, 1983

Mr. Alan Granwell
International Tax Counsel
Department of Treasury
3064 Main Treasury
15th & Pennsylvania Ave. N.W.
Washington, D.C. 20220

Dear Mr. Granwell:

The purpose of this letter is to transmit technical comments on the Reagan Administration's proposed Foreign Sales Corporation (FSC) legislation.

Monsanto Company is a major multinational chemical company headquartered in St. Louis, Missouri. Monsanto has investments in 166 manufacturing plants, laboratories, and technical centers in 20 nations employing 52,000 people. Monsanto maintains sales offices or sales agents in 65 foreign countries selling more than 1,000 products in 100 countries. These include chemical, agricultural, plastic, man-made fiber, and electronics products. Monsanto is a major exporting company, and in 1982 had approximately $900 million of export sales, representing 18% of Monsanto's total United States sales.

Monsanto has always been a strong and consistent supporter of DISC. DISC was a significant positive factor considered by Monsanto in its decision to locate a large agricultural chemical plant in the United States rather than a foreign location. Monsanto continues to believe in the necessity of a tax incentive for exports and is encouraged by the Administration's proposal for a Foreign Export Sales Corporation. Because we support passage of the FSC legislation (with the changes reflected in the technical comments), we are submitting these comments, which are designed to make FSC workable and effective in accomplishing its intended purposes, for your consideration.

Our comments are as follows. Section numbers refer to sections of the proposed legislation.

1. Participation--§ 924(d)(1)(A)

   This subsection requires that the FSC or any person acting under a contract therewith participate outside the U.S. in the solicitation, negotiation, or the making of the contract relating to the export transaction. Many taxpayers will contract with related incorporated sales subsidiaries to perform solicitation, negotiation, or the making of the contract for the FSC. If such foreign sales subsidiary (the contractee) is required to perform these functions as an agent of the FSC, the FSC would probably be subject to tax in the foreign country since the existence of a dependent agent would almost certainly be considered a "permanent establishment" in that country. This problem can be eliminated by defining "participate" in such a way that the contractee need not be an agent of the FSC. Thus, this section should include a definition of "participation" as follows:

   "Participation includes situations where such corporation contracts outside the U.S. with another person to perform one or more of the enumerated functions, irrespective of whether the other person is an agent of such corporation. The other person may be a related party and may subcontract the performance of the enumerated functions."

   It is anticipated that under this provision the FSC would contract with a foreign sales subsidiary of its parent to solicit orders for the account of such foreign sales subsidiary, which would in turn be obligated to fill the orders by purchasing from the FSC. The foreign sales subsidiary might subcontract this sales solicitation effort if that is a desirable marketing pattern. Such a contract would meaningfully relate the sales effort of the foreign sales subsidiary to the sales made by the FSC, but would not involve the FSC in a way which would invite direct foreign taxation of the FSC.

   It is noted that such a contract is entirely reasonable from a commercial standpoint. The consideration for the services of the foreign sales subsidiary is its resale margin or commission, which is paid by the FSC.

2. Total Direct Costs--§§924(d)(3)(A)&(B)

These sections define total direct costs and foreign direct costs. The definition in Subsection (A) includes activities performed at any location by the FSC or any person acting under a contract with such FSC. The definition in Subsection (B) of foreign direct costs makes no reference to persons acting under a contract with such FSC. To clarify this, the "person acting under a contract with such FSC" language should be repeated in Subsection (B) or the definition in Subsection (B) should read, "total direct costs as defined in Subsection (A)."

3. Freight Terms--§ 924(e)(3)

This provision refers to the cost of transportation from the time of acquisition by the FSC to the delivery to the customer. Cost compilation might be affected by the terms of sale. Under CIF terms (Cost, Insurance, and Freight), the shipping charges are separately identified on the invoice and/or related documents. In this instance, it might be argued that the seller is arranging for insurance coverage and freight as agent of the purchaser since the cost of these items are passed through without markup. In contrast, under FOB terms (Free on Board), the freight charges do not appear as separate items on the invoice, and clearly such costs are borne by the seller on its own behalf. The inclusion or noninclusion of freight in the direct costs test should not be dependent upon the formal terms of sale, since the two terms effect the same economic result. The actual freight paid by the FSC should be included irrespective of the terms of sale (CIF or FOB).

4. Transfer Pricing Rules--§ 925

This section states the transfer pricing rules. This section should be rewritten such that the transfer pricing standard is stated to be the arm's length price with the particular pricing rules being stated as safe haven rules within the arm's length standard. This restatement of the transfer pricing rules will enhance the position of the U.S. as to the European GATT parties.

5. Computation of Combined Taxable Income--§ 925(b)

This provision provides rules for commissions, rentals, and marginal costing. The same language is used as appears in the DISC legislation under § 994(b). We agree with the use of the same language. The existing rules for computing combined taxable income, including marginal costing and related grouping of transactions, are provided under § 994 of the DISC law and regulations issued thereunder. These rules are complex, but by now users of DISC are familiar with them. They should not be changed because change will create unnecessary work for the IRS and for taxpayers. In addition, changing these rules will render invalid the basic planning assumption on which the FSC legislation is based, i.e., that an exemption of 17% of FSC income (which is computed with reference to combined taxable income) will be equivalent to the average benefit now received by DISC users. If the computation of combined taxable income is changed, the amount of the benefit will change.

Accordingly, we believe that the following language should be added to § 925(b).

> "Regulations pertaining to commissions, rentals, and marginal costing, including related grouping, issued under this section shall be the same as regulations issued under § 994 as of the date of enactment of the FSC legislation."

6. Carrying Charges--§ 927(d)(1)(B)

This section defines carrying charges, which are taxed under § 921 of the FSC legislation, as effectively connected income, as including any amount in excess of the price for an immediate cash sale. We think it unreasonable to subject to taxation unstated interest on any terms other than a cash sale when export transactions commonly have terms of from 60 to 180 days. We think the § 482 standard of 180 days for trade receivables should be applied in this instance such that no interest income is attributed to receivables up to 180 days.

7. Grouping--§ 927(d)(2)(B)

This section permits grouping of transactions apparently for all purposes under FSC based on product lines or recognized industry or trade usage. We agree with the grouping concept. Our comments are:

(a) We believe that grouping of transactions is essential to operation of an FSC without the unnecessary expense and effort of separate accounting for each transaction. While we recognize that the Commissioner should issue regulations implementing the grouping rules, we believe the basic permission to group based on product lines or recognized industry or trade usage should not be discretionary with the Commissioner.

(b) Grouping based on product lines or recognized industry or trade usage is more restrictive than the grouping currently permitted for DISCs under § 994 of the Code. Any change in the grouping rules used for computing combined taxable income will change existing procedures and will alter the ultimate benefit to be derived from the FSC legislation. (See comments on marginal costing above.) Therefore, an exception should be stated in § 927(d)(2)(B).

To implement the foregoing, this provision should read as follows:

"(B)Grouping of transactions. Any provision of this subpart which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Different groupings for different purposes are permitted. Provided, this section is not applicable to the rules for commissions, rentals, and marginal costing, which are governed by § 925(b) of this legislation and § 994 of the DISC legislation and the Regulations thereunder."

8. Source Rules--§ 927(e)(1)

This section relates to source rules for related persons and would appear to require parallel calculations under the DISC pricing rules. Such parallel calculations are burdensome and should not be required. The meaning of this section should be clarified.

9. Election of Status of FSC--§ 927(f)

This provision requires that an election shall be made by the FSC any time during the 90-day period immediately preceding the beginning of its taxable year. Such election should be permitted to be made within 90 days after the beginning of the taxable year.

10. Effective Date and Transition Rules--§ 4

(a) Under § 4 relating to effective date and transition rules, it appears that DISCs operated after 1/1/84 will not obtain the full benefits as under existing law. In other words, the bill imposes a 1/1/84 cut-off date which forces taxpayers to gear up to operate under the FSC by 1/1/84 even if this statute is enacted late in 1983. It would be better to provide at least a 6-month transition period after the enactment of the bill under which taxpayers could operate under either a DISC or a FSC and obtain full benefits (provided, of course, that no transaction would receive benefits of both the DISC and the FSC). It is very difficult for taxpayers to change their operations and accounting procedures to comply with the FSC law in the short time between enactment and 1/1/84.

(b) If the bill is enacted in 1984, we feel a 6-month transition period should be used under these circumstances as well.

(c) In addition, since the proposed bill ends the tax year of existing DISCs on 12/31/83, it appears that existing DISCs will be required to satisfy the assets tests of § 992(a)(1)(B) as of 12/31/83. This can be burdensome where the DISC is on a fiscal year basis and is not used to qualifying on 12/31/83, and also because it is uncertain when the law will be enacted. Since the asset qualification tests are in effect being abandoned anyway by adoption of the FSC legislation, a provision should be included expressly eliminating the asset qualification test for DISCs on 12/31/83 if the shareholder uses an FSC thereafter.

(d) We think the same principle should be used if FSC is enacted in 1984, i.e., the asset qualification test for the end of the last year of DISC qualification should be expressly eliminated.

We commend your efforts to draft and support an alternative to DISC which will satisfy the objectives of the other parties to the General Agreement on Trade and Tariffs. We have submitted these comments to help make the FSC legislation workable and effective.

Sincerely yours,

Richard A Overton

R. A. Overton
Director
Corporate Taxes

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bcc: D. S. Brown 1920
R. E. Federer
T. J. Mahler
R. T. Pavlack

Senator DANFORTH. Mr. Scott.

STATEMENT OF ROBERT T. SCOTT, VICE PRESIDENT, TAXATION, JOHNSON & JOHNSON, NEW BRUNSWICK, N.J.

Mr. SCOTT. Thank you, Mr. Chairman.

My name is Robert Scott. I am vice president for taxation with Johnson & Johnson.

We want to thank you for the opportunity to appear before you. We endorse all of the statements of the public and private witnesses that have been heretofore made on the FSC or the FSC, and I would like to just limit our comments briefly on section 2(c) of the bill.

While that section has no relation to export incentives, nonetheless if the section is to remain, we have two suggestions. One would be with respect to the factoring of foreign receivables. The factoring of receivables by a controlled foreign corporation which arise from the sale of goods manufactured abroad by another controlled foreign corporation for ultimate use in consumption abroad does not—unless the transaction generates subpart F income—have any connection with the United States.

The income derived by a controlled foreign corporation from factoring this type of income—or this type of receivable—should not be subjected to current taxation by the Unites States. Now, it is my understanding that S. 1804 has two objectives.

One is to encourage U.S. exports through the Internal Revenue Code and the second is to make certain that any change that will come about does not result in any net revenue loss to the Treasury.

Neither of these objectives would be adversely affected by excluding from the scope of section 2(c) the receivables from the sale of goods manufactured abroad by a foreign corporation or for destination or for consumption abroad. Receivables which arise in base company transactions should be subjected to subpart F.

It seems to me that there is no reason to defer the U.S. tax on a sale of goods produced abroad and sold abroad from current U.S. taxations, but then to impose a current U.S. tax on the factoring income when a receivable from that sale is discounted, in an otherwise bona fide commercial transaction. The factoring of this type of receivable is revenue neutral from the U.S. standpoint, and the only tax effect is a reduction in the foreign taxes.

Now, I would submit that the reduction of foreign tax through legitimate commercial means should be encouraged and not discouraged by U.S. tax policy. In the long run, this can only benefit the U.S. Treasury.

The second item that I have on page 3 of my statement deals with another way that the committee might consider in providing for an additional or a supplemental export incentive. It deals with—and I won't go into it—the use of factoring to foster the U.S. exports. I think it is an intriguing idea and we would be happy to discuss it with the committee or the staff if you so desire. Thank you.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Robert T. Scott follows:]

STATEMENT OF ROBERT T. SCOTT
JOHNSON & JOHNSON
BEFORE THE SENATE COMMITTEE ON FINANCE
FEBRUARY 3, 1984

My name is Robert T. Scott. I am Vice President, Taxation,of Johnson & Johnson, which is the world's leading manufacturer of health care products. I am appearing before you today to testify on S.1804, which would provide for the creation of a foreign sales corporation to replace the current domestic international sales corporation (DISC) provisions.

As a matter of national policy, Johnson & Johnson believes some form of income tax incentive for exports is necessary and desirable. However, I intend to limit my comments primarily to section 2(c) of S.1804.

Section 2(c) of the bill provides that income earned by a controlled foreign corporation from factoring receivables purchased from any related corporation shall be taxed currently by the United States as subpart F income. This section is completely unrelated to either the Administration's foreign sales corporation proposal or to the existing DISC provisions and should be considered separately by this Committee.

However, if the Committee is to consider section 2(c), the scope of the section, as currently drafted, is entirely too broad*. The factoring by a controlled foreign corporation of receivables of another controlled foreign corporation arising from the sale of goods manufactured outside the United States destined for use or consumption outside the United States should be excluded from this provision.

The Factoring Pattern

The typical commercial factoring pattern involves the sale of a receivable by one corporation at a discount to another corporation. The liquidity of the selling corporation is immediately improved since it realizes cash (less the discount) for the receivables which have been sold. The selling corporation usually is relieved of any risk of the receivables not being collected in due course. The discount element of the transaction produces a deductible expense for the selling corporation. The factor, usually assumes the collection risk, services the receivable, collects the debt at face and thereby realizes a profit.

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*Income from the factoring of receivables can arise in at least four different types of sales transactions: (1) a sale by a U.S. corporation to a domestic customer; (2) a sale by a U.S. corporation to a foreign customer; (3) a sale by a controlled foreign corporation to a domestic customer; and (4) a sale by a controlled foreign corporation to a foreign customer. Each of these transactions has different effects on the U.S. economy and should be considered separately when determining what United States tax treatment should be accorded the discounting of the receivable arising out of the transaction.

Foreign to Foreign Factoring

The factoring of receivables by a controlled foreign corporation which arise from the sale of goods manufactured abroad by another controlled foreign corporation for ultimate use or consumption abroad does not, unless the transaction generates foreign base company sales income, have any connection with the United States. The income derived by a controlled foreign corporation from factoring this type of receivable should not be subject to current tax by the United States.

For example, if a controlled foreign corporation incorporated in country X sells $1 million of products produced in country X to its customer, the income earned on that sale will be taxed by the U.S. only when it is repatriated and a credit will be allowed for any country X income taxes paid on the sales income. The result should not be any different if the country X controlled foreign corporation discounts that receivable arising in such a sale to a related foreign corporation whether incorporated in country X or elsewhere.

Foreign owned country X competitors of the controlled foreign corporation will be able to discount their receivables, taking full advantage of the benefits of factoring, without an additional U.S. tax burden on the discount income. If country X has no objection to the factoring, and if the transaction is revenue neutral from the U.S. standpoint, there is no sound policy reason for imposing a current United States tax on this particular type of factoring income.

It is my understanding that there are two primary goals of S.1804: (1) to continue to encourage U.S. exports through the Internal Revenue Code and (2) to make certain that any change does not result in a net revenue loss to the United States. Neither of those objectives would be adversely affected by excluding from the scope of section 2(c) receivables arising from the sale of goods manufactured abroad by a foreign corporation for use or consumption outside the United States (or with respect to receivables arising from services rendered outside the United States). Receivables which arise from sales or other transactions which result in base company sales or service income could be included in the category of receivables the discounting of which would be treated as subpart F income.

There is no reason to defer U.S. taxes on the above described sale of the country X affiliate but then to impose a current U.S. tax on the factoring income when the receivable from that sale is discounted with a foreign affiliate in an otherwise bona fide commercial transaction. The factoring of the receivable is revenue neutral from the U.S. standpoint. The only tax effect is a reduction in country X taxes. The reduction of foreign tax through legitimate commercial means should be encouraged not discouraged by United States tax policy since, in the long run, this can only benefit the United States Treasury.

Additional Export Incentive

Under the Administration's proposal in section 2(c), the discounting of receivables of a U.S. affiliate by a controlled foreign corporation arising from the sale of goods destined for ultimate use and consumption in the U.S. would be subpart F income.

If this proposal were adopted, an additional export incentive could be created by allowing a U.S. affiliate, manufacturing goods in the United States for use or consumption outside the United States, to discount those export receivables with a controlled foreign corporation. The discount income realized by the controlled foreign corporation would not be subpart F income. Of course, as set forth above, the factoring of "foreign to foreign" receivables is U.S. revenue neutral and should not be treated as subpart F income.

In order to retain the same level of tax incentive provided by the DISC provisions, a dividend received deduction equal to all, or a portion of, the permitted discount on export trade receivables could be provided. A dividends received deduction (or credit) would be provided to the United States parent of the foreign affiliate factoring company only with respect to dividends attributable to income from the factoring of receivables arising in a transaction involving exports from the United States. All other distributions from the factoring company would be taxed in the normal course.

Prudent utilization of tax deferral or exemption with respect to income derived from discounting selected categories of export receivables should enable the United States to implement a GATT legal export incentive program which would be revenue neutral. I believe that this system may be easier to administer for both the Internal Revenue Service and taxpayers than either the current DISC provisions or the proposed foreign sales corporation bill.

I shall be happy to discuss these proposals with members of the Committee or appropriate staff members at any time convenient to you.

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Senator DANFORTH. Mr. Baldwin.

STATEMENT OF PAUL BALDWIN, VICE CHAIRMAN, GILMAN PAPER CO., NEW YORK, N.Y., ON BEHALF OF THE AMERICAN PAPER INSTITUTE

Mr. BALDWIN. Senator, my name is Paul Baldwin. I am vice chairman of Gilman Paper Co. With me is Alvin Yanofsky, senior tax attorney, international, of International Paper Co., and Michael M. Abend, director of tax planning and analysis of Gilman Paper Co.

We are appearing on behalf of the American Paper Institute, which represents over 165 companies which produce over 80 percent of the pulp and paper manufactured in this country. And we thank you for the privilege of being able to testify before this committee.

I am going to submit a statement of the American Paper Institute, but I will limit myself this morning to a summary of that statement.

Our industry is aware of the issues raised by our trading partners under the general agreement on tariffs and trade—GATT. Regarding the existing DISC tax-based export incentive, in order to help resolve these issues, our industry supports efforts to design a viable DISC substitute. The U.S. paper industry has a large number of DISC's and has an excellent record of export growth which can be related to DISC.

A significant portion of the industry's participation in foreign markets is through export. Without a suitable tax-based replacement, both large and small paper companies would have greater difficulty competing in world markets at a time when our country needs to increase its exports, particularly in light of significant U.S. trade deficits.

The American Paper Insitute strongly supports the proposed tax-based export incentive, but recommends reasonable clarification of certain key provisions in S. 1804, and certain legislative changes to facilitate use of that incentive by exporters.

We are particularly concerned with the administrative problems and costs faced by the smaller company. We recommend a significant increase over the present $2½ million amount allowable as foreign trading gross receipts of a small FSC. Furthermore, as noted in our detailed recommendations, we recommend that an alternative measure of a small DISC be provided, one that is based on taxable income.

We believe that S. 1804 is GATT compatible, but feel that this feature should be strengthened even further by adoption of our recommendation that the FSC not be subject to U.S. tax on a portion of its income. Shifting taxation to the shareholder level would strengthen the FSC's foreign presence.

API would be more than willing to work with this committee and the Treasury in any way that you would wish. Thank you.

Senator DANFORTH. Gentlemen, thank you very much.

[The prepared statement of Paul Baldwin for the American Paper Institute follows:]

STATEMENT OF
THE AMERICAN PAPER INSTITUTE
TO THE SENATE FINANCE COMMITTEE, FEBRUARY 3, 1984

My name is Paul Baldwin. I am Vice Chairman of Gilman Paper Company . With me is Alvin Yanofsky, Senior Tax Attorney, International, International Paper Company, and Michael M. Abend, Director of Tax Planning and Analysis, Gilman Paper Company. We are appearing on behalf of the American Paper Institute, which represents over 165 companies which produce over 90% of the pulp and paper manufactured in this country.

Our industry is aware of the concerns raised by our trading partners under the General Agreement on Tariffs and Trade (GATT) regarding the existing DISC tax-based export incentive. In order to help resolve these issues, our industry supports efforts to design a viable DISC substitute.

The export potential of U.S. paper companies would suffer without an acceptable DISC replacement. Several studies have indicated that the European Community, Japan and other foreign countries currently offer significantly greater incentives to their exporters than have ever been available to U.S. exporters under the DISC provisions. Moreover, as you are well aware, the DISC provision itself has been weakened in several tax measures since DISC was enacted in 1971. The latest revision was contained in the 1982 tax bill which further reduced the DISC benefit by including deferred DISC income as a tax preference item. But even at this lower tax benefit level DISC has been effective, and our current problem is development of a DISC substitute which does not result in any tax increase for exporters. Without a suitable tax-based replacement, both large and small paper companies would have greater difficulty competing in world markets at a time when our country needs to increase its exports.

The U.S. paper industry has an excellent record of export growth which can be related to use of DISCs by both large and small companies. A significant portion of the industry's participation in foreign markets is through exports. Between 1972 and 1981, U.S. exports of pulp, paper, paperboard and converted products increased from $1.1 billion to $4.9 billion. The worldwide recession reduced exports in 1982 to $4.3 billion.

The American Paper Institute strongly supports the proposed tax-based export incentive, but recommends reasonable clarification of certain key provisions in S. 1804, and certain legislative changes, to facilitate the use of that incentive by exporters. In a separate Appendix to this statement we have analyzed the foreign presence issue, and several other issues as well, and recommended specific approaches.

Our industry representatives appreciate the work of USTR and Treasury in clarifying the foreign presence requirements, but these and other rules impose a greater compliance burden on both large and small exporters than the current DISC provisions. Nevertheless, our member companies support this legislation and are prepared to meet its requirements.

In addition to the items outlined in this attachment, we want to express particular concern with the administrative problems and costs faced by smaller companies. Two suggestions would be to significantly increasee present $2,500,000 amount allowable as foreign trading gross receipts of a small FSC and to provide an alternative measure of a small FSC on the basis of taxable income. In any case, however, attention should be devoted to easing the compliance and cost burden on small companies, in order to permit these companies to realize their full export growth potential.

In conclusion, I would like to offer one final comment on the broad issue of GATT compatibility.

We believe that S. 1804 is GATT compatible, but feel that this feature would be strengthened even further by adoption of our recommendation that the FSC not be subject to U.S. tax on a portion of its income. Eliminating this requirement and shifting taxation to the shareholder level would provide the FSC with a strong foreign presence.

Our final broad recommendation refers to effective and appropriate implementation of this legislation. It is essential that Committee Report language clarify and/or explain legislative language so that Treasury regulations properly reflect Congressional intent in all areas.

We thank you very much for this opportunity to present our views. Our detailed recommendations are contained in the attached Appendix.

APPENDIX

STATEMENT OF

THE AMERICAN PAPER INSTITUTE

TO THE SENATE FINANCE COMMITTEE

FEBRUARY 3, 1984

API strongly supports the proposed tax-based export incentive, but recommends reasonable clarification of certain key provisions in S. 1804, and certain legislative changes to facilitate the use of this incentive by exporters.

Our analysis of this proposed legislation raises certain concerns. Listed below are the major issues, and recommended specific approaches to deal with these problems. Items 2 A-D would require appropriate legislative amendments.

1. A. Requirement That Economic Processes Take Place Outside The U.S. - Reasonable Clarification Needed

In order for export businesses to utilize the FSC incentive there needs to be reasonable interpretation of terms used in these paragraphs. Good progress has been made by the Administration in clarifying such terms as "making of contract," "advertising" and "sales promotion." It is essential, however, that such interpretation be confirmed in the Committee Report so that subsequent regulations will properly reflect Congressional intent. Definitions that focus on the required form of the transactions and provide safe harbor tests should be contained in the Committee Report, where the legislation is ambiguous. These tests must place emphasis on the technical aspects of the transactions. Examples of these would be:

a) Formal acceptance of orders satisfy the "making of contract" requirement,

b) only formal meetings need be taken into account in satisfying the "foreign meetings of the Board of Directors and shareholders" requirement, and

c) written authorizations provided to foreign board members or officers should be considered foreign actions.

Further, since it is required that the FSC incur a certain percentage of various costs, it is essential that the types of includable costs be clearly defined so that the total (the denominators of the fraction) can be determined with certainty.

B. Pricing Regulations

FSC transfer pricing rules should include all rules contained in the existing DISC pricing regulations, including but not limited to marginal costing and grouping.

C. Commission FSC

Clarification is required as to how an FSC will operate in the case of a commission FSC.

2. PROPOSED AMENDMENTS

A. U.S. Taxation of FSC Income

The FSC is not subject to U.S. tax on exempt foreign trade income. The FSC is, however, subject to tax on foreign trade income other than exempt foreign trade income and also on dividends, interest, royalties and other investment income. The shareholders of the FSC are allowed a 100% dividend exclusion on exempt and non-exempt foreign trading income, but not on investment or other income.

A better approach would be to treat the FSC as not subject to any U.S. taxation. As is the case with DISC, taxation would only be at the shareholder level. The dividend exclusion could be adjusted to arrive at a "revenue neutral" position (as, for instance, the proposal contained in Boren, S. 28). This would allow an offset for any parent company losses, which is currently available as an offset to distributions from a DISC. Although FSC dividends could be deemed to its shareholders, we recommend that this not be accomplished through the "Subpart F" provisions of the Internal Revenue Code. To avoid the complexities of "Subpart F" we suggest that the FSC deemed distribution requirements be established in a separate new Section (such as was established for the DISC; e.g., Sec. 995).

In this case, the shareholders would file an information return on behalf of the FSC but the FSC would be relieved from all other U.S. tax return and tax payment requirements. The principal shareholder of the FSC could be required to maintain complete books and records of the FSC at a location in the United States.

One of the objectives of the DISC replacement legislation is to make the replacement (FSC) GATT compatible. This is accomplished by giving the FSC a foreign presence. We feel that requiring the FSC to be subject to U.S. tax on a portion of its income weakens the FSC's foreign presence position. On the other hand, if the taxation is shifted to the shareholder level, the foreign presence argument is strengthened.

B. Taxable Year Requirement

The bill includes a requirement that the FSC adopt the same taxable year as its largest shareholder. The present DISC rules do not include this requirement and we see no reason for the FSC to be under a more restrictive rule. We believe that allowing a FSC the same freedom of selecting a taxable year as other foreign corporations strengthens its foreign presence posture.

C. Transitional Rule - Eliminate Qualified Assets Test

As the transition rules for elimination of DISC now specify in this proposal, all DISCs will cease to exist on December 31, 1984. This provision applies not only to calendar year DISCs, whose fiscal years would ordinarily end on this date, but also to fiscal year DISCs, whose year-ends ordinarily would not fall on December 31. As a result, a great many more DISCs will be required to meet the 95% assets test on December 31, 1984, and the supply of PEFco obligations may very well be insufficient to meet the total demand of the DISC community. Some DISCs, perhaps many, will be unable to purchase the PEFco obligations needed to qualify their balance sheets, with consequential loss of qualified status.

In order to prevent this unfair and unintended consequence, it is recommended that the qualified assets test be eliminated for all DISCs, effective December 31, 1984. Other tests, such as the qualified receipts test, will suffice to insure that DISCs remain qualified at December 31, 1984.

An alternative approach would be to allow fiscal year DISCs to continue until the end of the fiscal year ending after December 31, 1984.

D. Need for a Phase-in Period.

This proposal would require most exporters to establish a foreign office by its effective date. Setting up this office would require decisions as to staffing, location, and functions and would represent a significant modification to most exporters' operations.

To afford exporters an opportunity to establish this office in a reasonable manner, it is recommended that the proposal provide for a period of at least one year after its enactment during which the taxpayer would qualify for the benefits of the proposal without having to meet the foreign presence requirements.

PROPOSED AMENDMENTS

2. A. (1) EXAMPLE - FSC WITH NO INVESTMENT INCOME

	Administration Bill (FSC Subject to U.S. Tax)	Alternative (FSC Not Subject to U.S. Tax)
Export Taxable Income	$1,000	$1,000
Allocable to FSC @23%	230	230
Exemption (17/23 x 230)	170	-
Net Subject to U.S. Tax	60	-
U.S. Tax @46%	28	-
Earnings and Profits	202	230
Dividend Deduction(100%)	202	(74%) 170
Taxable to Shareholders	-	60
U. S. Tax on Shareholders @46%	$ -	$ 28

2. A. (2) EXAMPLE - FSC WITH INVESTMENT INCOME

	Administration Bill (FSC Subject To U. S. Tax)
Export Taxable Income	$1,000
Allocable to FSC @23%	230
Other Non-Foreign Trading Income (Interest, Dividends, etc.)	100
Total FSC Taxable Income	330
Exemption (17/23 x 230)	170
Net Subject to U.S. Tax	160
U. S. Tax @46%	74
Earnings and Profits	256
Dividend Deduction (170 + 60 - 28)	202
Taxable to Shareholders	54
U. S. Tax on Shareholders @46%	$ 25

Senator DANFORTH. Very good testimony. I take it all of you believe that some sort of tax program—FSC or DISC is essential in doing business in the world market today, that tax policy certainly affects the ability of people in other countries to export their products and that the United States has to be competitive and have some program, whether a continuation of the DISC, or whether it is this new program.

Senator CHAFEE. Senator Dole.

Senator DOLE. I didn't get that comment about gross receipts or taxable income. I am trying to find it in your statement.

Mr. BALDWIN. Are you speaking to me, sir?

Senator DOLE. Yes.

Mr. BALDWIN. It is not in my statement. We added that later in the summary.

Senator DOLE. Now, I don't know that I quite understand that.

Mr. BALDWIN. What we are saying is that there are two possibilities. One is the sales—$2½ million limit for small DISC's. The other alternative position would be to use a taxable income on the small DISC's rather than a $2½ million in sales. That is an alternative. Determining whether or not this is a small DISC or a large one.

Senator DOLE. Some, I think—chemical and paper—have a very low tax rate—almost a negative tax rate. We did a study on who pays taxes in America, and the chemical and paper industry were way at the bottom.

This must have been based on low earnings.

Mr. BALDWIN. I think that is somewhat reflective of the poor earnings we had. It is fairly long term, but again, I believe in the program. We are just trying to figure it out.

And again, as I understand it, most of the benefits of this program go to about 70 companies, and it is an expensive program from the point of view of revenue loss, so we need to be very careful in what we do.

Former Senator Mondale, voting against it in 1971. [Laughter.]

Senator DANFORTH. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman, and I want to thank you for holding these hearings today. As you know, I am a cosponsor of 1804. I would just like to ask unanimous consent to insert in the record my remarks that I would have made had I been here at the opening part, and I might just say to our chairman, Senator Dole, that this subject was discussed at great length upstairs in the Budget Committee earlier this morning by Senator Metzenbaum with Secretary Regan.

And the way it finally ended was that Senator Metzenbaum wanted the $13½ billion for the Treasury, and Secretary Regan asked him if he was willing to take the responsibility for having the balance of trade deficit get worse if we had to ask all those companies to fold their tents and come home. And Senator Metzenbaum then decided to go on and ask another question. So, that's where it was ended. [Laughter.]

Senator SYMMS. I know the question I want to ask should be asked to the next group of witnesses, and I will ask them but, in view of the fact that some of you don't represent what are normally called smaller companies, maybe I didn't quite understand what you were discussing with Senator Dole, but it was my understanding that under the old DISC provision, a small company could receive an interest free loan up to 40 percent or some such matter. And they can't do that now?

How is a small company going to take advantage of this advantage of this without some changes?

Mr. BALDWIN. I am only speaking for paper, but I would say that we have specifically pointed out that we feel that there should be a significant increase over the present $2½ million limit.

Senator SYMMS. Excuse me, but would you agree that maybe there should be some adjustments in the way we have this bill presently written, so that they could at least have the same advantage that they had in the past DISC?

Mr. BALDWIN. Yes

Senator SYMMS. And those of you from larger companies? Do you agree with that?

Mr. BALDWIN. Yes.

Senator SYMMS. OK. Thank you. Thank you, Mr. Chairman.

Senator DANFORTH. Gentlemen, thank you very much.

The next panel is Mr. Katz, Mr. Roush, and Mr. Mirabito.

Mr. Katz.

STATEMENT OF JULIUS KATZ, MEMBER, AMERICAN ASSOCIATION OF EXPORTERS AND IMPORTERS, NEW YORK, N.Y.

Mr. KATZ. Thank you, Mr. Chairman.

My name is Julius Katz. I am chairman of Donaldson, Lufkin, & Jenrette ACLI Futures, Inc., a commodity futures broker. The company is a subsidiary of ACLI International, Inc., a major international commodities trading firm.

A sister company of our group is a major independent exporter of fertilizers and agricultural chemicals and maintains an existing group. I am appearing here today on behalf of the American Association of Exporters and Importers.

With 1,400 U.S. company members nationwide engaged in the export, import, and distribution of goods and services worldwide, nearly half of the association's members are exporters. A large proportion of these exporters are small- and medium-sized companies. Still others are now—just now—launching export activities.

The association believes that the DISC program provides an important aid to exporters and opposes elimination of the program's benefits. The association supports the administration's good faith efforts to devise a satisfactory alternative which would meet the needs of U.S. exporters and resolve the dispute with some of our trading partners in the GATT. In introducing S. 1804, the Administration stated its intention to maintain the financial incentives of a DISC like substitute to maintain exporter use to avoid any tax increases for exporters and to insure that the FSC would continue to be usable by small businesses in particular.

AAEI fully supports these goals, but we believe, however, that the legislation as presently drafted falls short of meeting them in a number of areas, particularly and most critically as regards small- and medium-sized companies.

To correct these deficiencies, the association recommends that the committee make the following changes in the bill. The small FSC option should be expanded to allow businesses with up to $10 million in foreign trading gross receipts to take full advantage of this option for a transitional period of 5 years during which time the definition of a small FSC would be phased down to $5 million.

The qualified assets requirement of the DISC option should be eliminated to permit flexibility in corporate allocation of resources. This is particularly critical for small exporters and new-to-export firms.

The relationship between joint FSC's and the Commerce Department—certified export trading companies may need clarification if export trading companies are expected to organize joint FSC's for other companies. Antitrust protection now available to export trading companies' shareholders does not extend to their suppliers. A new certification procedure may need to be drawn up.

The factoring of receivables provides an important source of financing for many domestic and multinational companies, and section 2(c) would make it more difficult for American and multinationals to finance U.S. exports. We believe that the inclusion of the factoring provision is inappropriate if the bill is intended to promote U.S. exports.

My full statement provides an explanation of these proposals. Thank you, Mr. Chairman. I would be pleased to answer any question that members of the committee may have.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Julius Katz follows:]

TESTIMONY OF THE AMERICAN ASSOCIATION OF EXPORTERS AND IMPORTERS—HEARING ON THE FOREIGN SALES CORPORATION ACT (S. 1804) PRESENTED BY JULIUS KATZ

Mr. Chairman, members of the Committee:

The American Association of Exporters and Importers (AAEI) welcomes this opportunity to share our concerns about the Administration's proposal to replace the DISC Program with a new Foreign Sales Corporation Program and to offer recommendations to ensure that any alternative meets the needs of U.S. exporters, both large and small.

My name is Julius Katz, I am Chairman of Donaldson, Lufkin & Jenrette ACLI Futures Inc. This company is a commodities future broker. It is a subsidiary of ACLI International Incorporated, a major international commodities trading company. A sister company of our group is a major independant exporter of fertilizers and agricultural chemicals and maintains and existing DISC.

I am appearing today as a member of AAEI's Export Committee and its Executive Committee. As a former Assistant Secretary of State for Economic and Business Affairs, I am personally interested in the international trade and domestic economic aspects of the legislation before this Committee. I believe they are also a matter of critical importance to the nation as a whole.

With 1,400 U.S.-company members nationwide engaged in the export, import and distribution of goods and services worldwide, nearly half of AAE.'s members are exporters. A large proportion of these exporters are small and medium-sized companies. Still others are just now launching export activities.

AAEI believes that the DISC Program provides an important aid to U.S. exporters who must compete in the international marketplace with foreign competitors who enjoy the benefit of taxation systems which are more favorable to exporting than is the American system.

AAEI opposes elimination of the Program's benefits. AAEI supports the Administration's good faith effort to devise a satisfactory alternative which will meet the needs of U.S. exporters and resolve the dispute with some of our trading partners in the General Agreement on Tariffs and Trade.

In introducing S. 1804, the Administration stated its intention to maintain the financial incentives of a DISC-like substitute to maintain exporter use; to avoid any tax increases for exporters; and to ensure that the Foreign Sales Corporation (or FSC) would continue to be usable by small businesses in particular.

AAEI fully supports these goals. We believe, however, that S. 1804, as it is presently drafted, falls short of meeting them in a number of areas, particularly and most critically as regards small and medium-sized companies.

To correct these difficiencies, AAEI recommends that the Committee make the following changes in S. 1804:

- The "Small FSC" option should to expanded to allow businesses with up to $10 million in foreign trading gross receipts to take full advantage of this option for a transitional period of five years, during which time the definition of a "Small FSC" would be phased down to $5 million. This approach would give those small businesses with more than $2.5 million in foreign sales the time they need to comply with the fuller FSC foreign activity requirements.

- The "qualified assets" requirements of the DISC option should be eliminated to permit flexibility in corporate allocation of resources. This is particularly critical for small exporters and new-to-export firms.

- The relationship between "Joint FSCs" and Commerce Department - certified Export Trading Companies may need clarification if ETC's are expected to organize joint FSCs for other companies. Antitrust protections, now available to ETC shareholders, do not extend to their suppliers. A new certification procedure may need to be drawn up.

- "Factoring" of receivables provides an important source of financing for many domestic and multinational companies. Capital earned by the U.S. parent may be used to finance further exports. Section 2(c) of S. 1804 would alter the tax treatment of income earned by a foreign subsidiary which purchases the receivables of a related company, such that a U.S. parent company would be taxed currently on its income even if it is not distributed to the parent. As Section 2(c) would make it more difficult for American multinationals to finance U.S. exports, we believe its inclusion is inappropriate in a bill intended to promote U.S. exports.

Thank you, Mr. Chairman. I would be pleased to try to answer any questions the Committee may have.

Senator DANFORTH. Mr. Roush.

STATEMENT OF MICHAEL ROUSH, LEGISLATIVE REPRESENTATIVE, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, D.C.

Mr. ROUSH. Yes, Mr. Chairman. I am the Legislative Representative for the National Federation of Independent Business. In general, NFIB supports the proposal as the administration has worked it out. I will restrict my comments to four concerns that we have with it, the first two of which could be taken care of in legislative history.

The second two—perhaps at some point in the future—would need statutory changes. First is that the offshore presence test needs to be as simple and as uncomplicated as possible. As I say, in legislative history, that could perhaps be discussed.

The second thing that legislative history could perhaps discuss is the area of the multiple ownership of an FSC concept that is perhaps the most potentially valuable part of the proposal, but it needs to be filled out a little more. In the Treasury explanation of the bill that was suggested this area is not very well discussed, and again, perhaps legislative history could discuss it at more length, particularly how it is to dovetail with the Export Trading Company Act.

The second two proposals—the second group—the third and the fourth concerns we have are dealing with the foreign trade in gross receipts threshold level of 2½ million.

We believe at some point it might be necessary to look at raising that, and the fourth concern is that we also, as other witnesses have said, think that at some point it should be looked at to expand the concept to service companies and computer companies.

Those last two are real concerns, but why I say possible future statutory language is that to the extent that either of them or both of them together could be shown to substantially increase the loss to the Treasury, we would not support them at this time.

Senator **Danforth**. Thank you, sir.

[The prepared statement of Michael O. Roush follows:]

NFIB® National Federation
of Independent Business

The Guardian of Small Business

STATEMENT OF

MICHAEL O. ROUSH
LEGISLATIVE REPRESENTATIVE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	Senate Finance Committee
Subject:	S. 1804, The Foreign Sales Corporation Act of 1983
Date:	February 3, 1984

My name is Michael Roush, Legislative Representative for the National Federation of Independent Business (NFIB). On behalf of the more than 560,000 members of the NFIB, I appreciate the opportunity to comment on S. 1804, the Foreign Sales Corporation Act of 1983.

Since 1971, the Internal Revenue Code has provided a special tax incentive for exporters through its Domestic International Sales Corporation (DISC) provisions. This incentive permits an exporter to defer indefinitely payment of Federal taxes on a portion of the firm's export income, thereby providing exporters with an incentive to increase export-related activities. Through the DISC incentives, Congress had hoped to stimulate export activities and reduce our balance of trade deficit while simultaneously increasing employment in export related activities.

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In 1971, as now, our domestic economy suffered from a deficit in our balance of trade accounts, and it was hoped that the DISC incentives would spur American investment into exports. The DISC rules were initially designed to equalize treatment with our foreign trading partners whose exports are directly subsidized.

S. 1804 proposes a replacement of the DISC tax incentive with a new concept entitled the Foreign Sales Corporation (FSC). The FSC will be an incentive proposal much the same as DISC, but will also be compatible with our treaty obligations under the General Agreement on Tariffs and Trades (GATT).

Recently released statistics by the U.S. Department of Treasury provide an illustration of the extent to which small exporters utilized the DISC incentives. The data reveals that 48% of all DISC returns filed were companies with less than $5 million in assets. Additionally, 30% of all DISCs were owned by small corporations.

While many small firms utilized DISC, many other small exporters declined to take advantage of DISC. In a non-scientific phone survey of exporters, several reasons were given for the limited use of DISC. They include: insufficient dollar amounts in repeat export activity to warrant establishing a separate DISC subsidiary; technical concerns about how a DISC owner would repatriate tax-deferred dollars, the major incentive provided by the DISC rules; and the complex reporting requirements and qualifications for maintaining a DISC.

Why DISC only partially succeeded in increasing the exports of small business is a question worth exploring at this time. If the Foreign Sales Corporation (FSC) proposal is to succeed in its purpose. i.e. stimulating exports, the needs of small exporters and potential exporters need to be considered carefully.

S. 1804 proposes a dramatically revised and simplified incentive for exporters, both large and small. The FSC provisions will allow a permanent tax deferral on export earnings because the FSC will be incorporated and located outside the United States. Locating the FSC outside of the United States means that the FSC earnings are not taxable in the United States. Further, any dividends distributed to FSC shareholders will not be taxable if certain requirements are met for export revenues.

In general, revenues will qualify as FSC receipts if certain minimum foreign presence tests and certain economic processes take place outside of the United States. FSC income would be determined by use of an arm's length pricing method, which is required by Gatt rules and the IRC.

Large exporters will probably find this new proposal substantially in line with their present method of operations and will find very few problems in adapting to the FSC methodology. However, small exporters need to be concerned over how they will comply with the FSC rules and with the foreign presence requirements within FSC.

S. 1804 presents three options for the small exporter. The first option is eligible to exporters with $10 million or less in export receipts; that is to continue to use the DISC rules, with one modification. DISC earnings need not be distributed to shareholders, thereby granting a permanent deferral on total DISC earnings. If this option is chosen, the Federal government will assess an interest charge on the tax deferral each year on a cumulative basis. This option is probably the least attractive one to small exporters, who would still be saddled with DISC and would not have the FSC tax incentives.

The second option is available to firms with less than $2.5 million in export receipts. Under a simplified FSC arrangement, the small exporter would not have to perform economic activities outside the United States. However, a small FSC would still have to satisfy the requirements for foreign incorporation, would need to maintain an offshore office with appropriate accounting records, and maintain a director to reside abroad.

The specific details on the exact degree of foreign presence which would be required of a small exporter have yet to be defined.

These details are crucial if this proposal is to be considered attractive by small exporters. Pending release of these details, NFIB will withhold its unconditional endorsement of this proposal because the fine details may make a substantial difference in how a proposal of this type could be utilized. If growth in the number of small exporters and growth in export receipts is desirable public policy, it is in everyone's interest to insure that small exporters face as few legal and tax battles as possible in utilizing this new tax idea.

Another point worth reviewing is the question of where one draws the line between large and small exporters. Currently the distinction is made at $2.5 million in export receipts. The 1980 Treasury statistics revealed that exporters with $5 million in assets generated only about 5% of DISC income. Further study should be done to determine whether the level of $2.5 million is high enough to be a sufficient incentive to export. Perhaps the export receipts level needs to be raised to $5 million for purposes of a small FSC designation, because it may require a fairly large exporter to comply with the foreign presence and economic processes tests.

A third provision of S. 1804 which I consider very innovative and possibly crucial to growth of small business exports is the proposal to allow multiple ownership of a FSC. This would allow the occasional exporter and the very small volume exporter to participate in the FSC tax benefits. With little up front investment in money and material required, small exporters may find this concept attractive, and the Commerce Department will be able to piggyback this concept onto the export trading company rules as an incentive to potential small exporters.

Summary

The FSC proposal eliminates many of the problems small exporters found with DISC. In designing the new FSC proposal, however, Congress must be careful to avoid complication of off-shore presence tests which will have the undesirable impact of curbing exports. To provide incentives for small exporters, the foreign presence tests need to be as abbreviated as possible and to carry a revenue limit which will ensure that only mature firms need qualify for additional foreign presence tests.

The multiple FSC concept, based loosely on the Export Trading Company model, could be the most useful provisions in S. 1804 for new and small exporters. This new concept in exporting may be the wedge we are seeking to expand the growth in exports by small firms.

Mr. Chairman, as you can see, it would not require very dramatic changes to the Administration's proposal to ensure that FSC benefits are made available to small exporters. With these three concerns properly addressed, NFIB members would feel very comfortable supporting S. 1804, the Foreign Sales Corporation Act of 1983.

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Senator DANFORTH. Mr. Mirabito.

STATEMENT OF JASON MIRABITO, ESQ., BOSTON, MASS., ON BEHALF OF SMALL BUSINESS UNITED

Mr. MIRABITO. Thank you. I am Jason Mirabito. I am an attorney and professor of law at Suffolk University, Boston, Mass.

I appear before you on behalf of SBU—Small Business United—and SBANE—the Small Business Association of New England. Much activity in the past has focused on U.S. exports, particularly those exports of small companies, including the SBA small export program, ETC legislation, and Eximbank.

The FSC is another important piece of legislation which I think we have to consider. I have a statement which I wish to have entered for the record, and I would like to make now several points drawn from that statement.

The first point is our belief that FSC benefits should be extended to service companies. Under the GATT, I believe it is permissible to extend DISC or FSC benefits to service companies, and this industry is particularly important in New England. Service companies are growing at a fast rate and their overseas business is likewise increasing at a fast rate.

The second point is a point that was made earlier by others. Exports of software should be entitled to DISC benefits. Another large industry and an industry made up of small businesses in Massachusetts and in New England in general is the computer software industry. Under present legislation, it is unclear whether computer software is entitled under DISC benefits. Arguably, the Service may take a position that it is not so entitled if it takes the same approach with respect to the definition of intangible property under DISC that is already used with respect to the investment tax credit for unbundled software.

Either legislative change or some clarification, I believe, is necessary.

Third point. I believe the $2.5 million ceiling for small DISC's is inadequate. I believe that the ceiling should be raised to $10 million at least, to encompass the large number of DISC's, the 85 percent of the DISC's, which earn less than $10 million. I think a fourth point is that the interest charge on small DISC's provided in the bill should be decreased. I believe there is no requirement under the GATT that legally requires the presently high interest rate.

Finally, I would like to state our support for joint cooperation among small companies under the FSC. I think it is essential to allow small business to act jointly together, or together with regional entities such as Massport in New England. Thank you.

Senator DANFORTH. Gentlemen, thank you very much.

[The prepared statement A. Jason Mirabito, Esq. follows:]

SBANE

SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

STATEMENT OF
A. JASON MIRABITO, ESQ.
REPRESENTING

SMALL BUSINESS UNITED
AND
THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.
BEFORE
THE SENATE FINANCE COMMITTEE

IN CONSIDERATION OF:
SENATE BILL S. 1804
ON
THE FOREIGN SALES CORPORATION ACT

FEBRUARY 3, 1984
WASHINGTON, D.C.

SBANE
SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, INC.

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, AND AUDIENCE:

I. INTRODUCTION

THANK YOU FOR INVITING US TO SHARE WITH YOU OUR ORGANIZATIONS' VIEW ON THIS VERY IMPORTANT PROPOSED PIECE OF LEGISLATION.

I APPEAR BEFORE YOU TODAY ON BEHALF OF SMALL BUSINESS UNITED, A NATIONAL COALITION OF SOME 14 METROPOLITAN, STATE, AND REGIONAL SMALL BUSINESS ASSOCIATIONS, AND SBANE, THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND, AN ASSOCIATION OF MORE THAN 2,000 MEMBER COMPANIES; MANY OF WHOM ARE SUCCESSFUL EXPORTERS OF VARIOUS INNOVATIVE PRODUCTS AND SERVICES.

II. OVERALL PERSPECTIVE

MR. CHAIRMAN, THERE HAS BEEN A GREAT DEAL OF GOVERNMENT ACTIVITY IN THE RECENT PAST, ALL FOCUSING ON EFFORTS TO STRENGTHEN THE U.S. EXPORT POSITION IN GENERAL AND SMALL BUSINESS EXPORTS IN PARTICULAR. EXAMPLES INCLUDE THE

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THE SBA EXPORT LOAN PROGRAM, THE EXPORT TRADING COMPANY ACT OF 1982, EXIM BANK EFFORTS TO REACH SMALL BUSINESSES, AND OVERSEAS PRIVATE INVESTMENT CORPORATION.

NEVERTHELESS, THERE ARE STRONG FORCES AT WORK CAUSING SMALL BUSINESS TO LOSE THE GROUND IN CAPTURING OVERSEAS MARKETS WHICH HAD BEEN GAINED DURING THE LATE 1970'S. MUCH OF THIS IS CAUSED BY THE ABSENCE OF A MONETARY POLICY TO KEEP THE DOLLAR EXCHANGE RATE WITHIN REASONABLE PARAMETERS AGAINST OTHER CURRENCIES. MANY SMALL EXPORTERS HAVE LOST UP TO FIFTY PERCENT OR MORE OF THEIR EXPORT GAINS, AND THIS HAS HAPPENED IN A TIME SPAN OF LESS THAN TWENTY-FOUR MONTHS.

DURING THE LAST DECADE, THE AMERICAN ECONOMY IN GENERAL, AND THE NEW ENGLAND ECONOMY IN PARTICULAR, HAS WITNESSED THE FORMATION OF MANY NEW COMPANIES, MANY OF WHICH OFFER INNOVATIVE PRODUCTS AND SERVICES TO THE MARKETPLACE. THE LONG TERM SURVIVAL AND PROSPERITY OF MANY OF THESE COMPANIES DEPENDS ON THEIR ABILITY TO ENTER, BUILD AND MAINTAIN STRONG POSITIONS IN INTERNATIONAL MARKETS.

SUPPLY-SIDE ECONOMICS, HOWEVER, DICTATES THE SLASHING OF GOVERNMENT BUDGETS FOR DIRECT EXPORT PROMOTION AT A TIME WHEN THE STIMULUS IS NEEDED MORE THAN EVER. WE ARE WITNESSING GOVERNMENT POLICIES WHICH SEEM TO CONTRADICT EACH OTHER AND WHICH TEND TO NEUTRALIZE, DIFFUSE, AND EVENTUALLY TO MINIMIZE THE EFFECTS OF ALL EFFORTS BY THE GOVERNMENT AND THE PRIVATE SECTOR TO BUILD A STRONG ECONOMY BASED ON SUBSTANTIAL EXPORTS OVERSEAS.

SBANE GENERALLY FAVORS A COMPREHENSIVE AND COHERENT LONG-TERM INTERNATIONAL TRADE POLICY WHICH TAKES ADVANTAGE OF EVERY POSSIBLE LEGALLY ACCEPTABLE OPPORTUNITY TO STIMULATE AND TO FACILITATE EXPORTS BY SMALL COMPANIES.

SMALL BUSINESSES ARE OFTEN AMONG THE MOST INNOVATIVE COMPANIES, AND MAKE A STRONG AND MEANINGFUL CONTRIBUTION TO THE WELL-BEING OF THIS COUNTRY THROUGH JOB CREATION AND EARNINGS FROM EXPORTS.

IN THIS CONTEXT, SBANE'S MEMBERS RECOGNIZE AND OBSERVE REPLACEMENT PROPOSALS OF PRESENT DISC LEGISLATION WITH A SENSE OF KEEN INTEREST. SBANE WOULD LIKE TO TAKE THIS OPPORTUNITY TO ADVANCE ITS COMMENTS BEFORE YOU ON SENATE BILL S. 1804.

III. COMMENTS ON THE PROPOSED LEGISLATION

A. DISC BENEFITS SHOULD BE EXTENDED TO SERVICE COMPANIES. SBANE STRONGLY ARGUES IN FAVOR OF THE INCLUSION OF ALL SERVICE COMPANIES, SMALL AND LARGE, FOR DISC BENEFITS. THE DISC LEGISLATION WAS ENACTED DURING THE EARLY 1970'S. SINCE THEN, AS WAS ELUDED TO EARLIER, THE NEW ENGLAND ECONOMY HAS WITNESSED THE EMERGENCE OF MANY NEW AND INNOVATIVE SERVICE COMPANIES, INCLUDING COMPUTER SERVICES, HUMAN CARE, PRIVATE SECTOR BUSINESS SUPPORT PROGRAMS, DATABANKS, RESEARCH AND CONSULTING COMPANIES. MANY OF THESE FIRMS HAVE SUBSTANTIAL OVERSEAS BUSINESS INCOME.

NEVERTHELESS, SERVICE COMPANIES, OTHER THAN CONSTRUCTION, ARCHITECTURE AND CERTAIN MANAGEMENT SERVICES, ARE INELIGIBLE FOR DISC BENEFITS. UNDER INTERNAL REVENUE CODE SECTION 993(A)(1)(G), GROSS RECEIPTS FROM ENGINEERING AND ARCHITECTURAL SERVICES FOR CONSTRUCTION PROJECTS OUTSIDE THE UNITED STATES ARE CONSIDERED QUALIFIED EXPORT RECEIPTS. THESE SERVICES MAY BE PERFORMED EITHER IN THE UNITED STATES OR ABROAD.

THERE ARE MANY OTHER TYPES OF SERVICES WHICH UNITED STATES COMPANIES, AND SIGNIFICANTLY SMALLER BUSINESSES, ARE PERFORMING, BOTH HERE AND ABROAD. THERE IS NO REASON WHY THOSE SERVICES NOT PRESENTLY COVERED BY THE DISC SHOULD NOT BE AND CANNOT BE. IN FACT, NOW IS THE PROPER TIME TO EXTEND DISC BENEFITS TO OTHER SERVICES. WE NOTE THAT THE CONGRESS, IN ENACTING THE EXPORT TRADING COMPANY ACT OF 1982, EXTENDED THE COVERAGE OF THAT ACT TO EXPORTERS OF SERVICES AS WELL AS TO EXPORTERS OF PRODUCTS. THE EARLIER WEBB-POMERENE ACT APPLIES ONLY TO EXPORTS OF PRODUCTS. THE CONGRESS THERE APPARENTLY RECOGNIZED THE IMPORTANCE OF THE SERVICE INDUSTRY IN THE UNITED STATES ECONOMY, BOTH DOMESTICALLY AND ABROAD. IT IS NOW TIME FOR THE CONGRESS TO ACT AND TO END THIS DIFFERENTIAL TREATMENT WHICH IS RECEIVED BY THE UNITED STATES SERVICE INDUSTRY.

WHILE IN THE NARROW SENSE OF THE WORD, THE EXTENSION OF DISC BENEFITS TO SERVICE COMPANIES MAY LEAD TO REVENUE LOSSES, THE BROADER VIEW DICTATES THAT THE JOB CREATION RESULTING FROM THE EMERGENCE OF THESE FIRMS IS OF PARAMOUNT

IMPORTANCE TO THE NATION. THIS PROCESS OF JOB CREATION PROVIDES WEALTH IN THE ECONOMY AND CONSEQUENTLY PROVIDES A STRONG TAX BASE.

B. EXPORTS OF SOFTWARE SHOULD BE ENTITLED TO DISC BENEFITS. AS YOU ARE DOUBTLESS AWARE, THE SOFTWARE INDUSTRY IS A RAPIDLY GROWING SECTOR OF OUR HIGH TECHNOLOGY ECONOMY AND SOFTWARE COMPANIES, WHO PROVIDE BOTH"PRODUCTS" AND SERVICES, ENJOY A COMPETITIVE ADVANTAGE OVER THEIR FOREIGN SOFTWARE COMPETITORS. YET, BECAUSE OF THE DEFINITION OF "EXPORT PROPERTY" UNDER THE DISC, FEW SOFTWARE COMPANIES HAVE BEEN ABLE TO AVAIL THEMSELVES OF THE DISC.

WE NOTE THAT THE FSC LEGISLATION MAKES LITTLE CHANGE IN THE EXPORT PROPERTY DEFINITIONS PRESENTLY SET FORTH IN IRC SECTION 993(C)(2)(B). THAT SECTION SPECIFICALLY EXCLUDES FROM THE DEFINITION OF EXPORT PROPERTY "PATENTS, INVENTIONS, MODELS, DESIGNS, FORMULAS, OR PROCESSES, WHETHER OR NOT THESE ARE ACTUALLY PATENDED, COPYRIGHTS (OTHER THAN FILMS, TAPES, RECORDS OR SIMILAR REPRODUCTIONS FOR COMMERCIAL/OR HOME USE), . . . OR SIMILAR PROPERTY."

DISC BENEFITS ARE INTENDED PRIMARILY FOR INCOME PRODUCED FROM THE EXPORT OF GOODS MANUFACTURED IN THE UNITED STATES, I.E., "EXPORT PROPERTY." A DISC MUST HAVE AS ITS PRINCIPAL FUNCTION THE SELLING, LEASING OR RENTING OF EXPORT PROPERTY FOR USE OUTSIDE THE UNITED STATES. IF THE PROPERTY THAT A CORPORATION SELLS OR LEASES IS NOT "EXPORT PROPERTY," THE CORPORATION DOES NOT QUALIFY AS A DISC.

ONE OF THE ORIGINAL JUSTIFICATIONS FOR THE DISC, AND PRESUMABLY NOW THE FSC, IS THAT THE TAX INCENTIVE ALLOWS U.S. CORPORATIONS TO PRODUCE IN THE UNITED STATES AND TO EXPORT THE FRUIT OF THEIR LABORS RATHER THAN DO SO ABROAD, THUS GIVING EMPLOYMENT TO U.S. WORKERS. IT MAY BE FOR THIS REASON THAT SECTION 993(c)(2)(B) WAS ENACTED (REGARDING THE DENIAL OF DISC BENEFITS FOR "INTANGIBLE PROPERTY.") THE REASONING, PERHAPS QUITE RIGHTFULLY SO, GOES AS FOLLOWS. IN A FOREIGN PATENT LICENSE OF A U.S.-OWNED FRENCH PATENT, THE U.S. COMPANY GIVES A FRENCH COMPANY THE RIGHT TO MAKE, USE AND SELL THE PRODUCT IN FRANCE. IF THE PATENT IS FOR AN INNOVATIVE ELECTRIC MOTOR, THE U.S. COMPANY/PATENTEE THUS GIVES THE FRENCH COMPANY THE RIGHT TO MANUFACTURE THE ELECTRIC MOTOR IN FRANCE. THIS HAS TWO EFFECTS, AT LEAST. ONE, FRENCH WORKERS ARE EMPLOYED TO MANUFACTURE THE ELECTRIC MOTOR, PROBABLY USING MATERIALS PURCHASED FROM OTHER FRENCH COMPANIES. TWO, WHAT MIGHT HAVE BEEN, WITHOUT THE LICENSE, U.S. EXPORTS TO FRANCE BY THE U.S. COMPANY/PATENTEE ARE DISPLACED IN PART OR IN WHOLE BY SALES OF THE LICENSED MOTOR BY THE FRENCH COMPANY/LICENSEE. THUS, U.S. WORKERS AND U.S. MATERIALS ARE NOT EMPLOYED AND PURCHASED, RESPECTIVELY.

THE SITUATION WITH REGARD TO EXPORTS OF SOFTWARE PROGRAMS IS ENTIRELY DIFFERENT. THE PROGRAMS ARE CONCEIVED, DEVELOPED, WRITTEN AND DEBUGGED, WITH APPROPRIATE DOCUMENTATION, BY

U.S.-BASED PROGRAMMERS, AND ARE USUALLY EXPORTED ABROAD IN THE FORM OF TAPES, FLOPPY DISKS, CARTRIDGES, ETC., TOGETHER WITH THE DOCUMENTATION. THERE MIGHT BE A TRANSLATION OF THE PROGRAM AND RELATED DOCUMENTATION INTO THE LANGUAGE OF THE COUNTRY OF DESTINATION (THIS TASK IS OFTEN PERFORMED IN THE U.S. BY SOME COMPANIES), BUT FOR ALL ESSENTIAL PURPOSES, THE SOFTWARE EXPORTED IS IN ALL SUBSTANTIAL WAYS A PRODUCT. IMPORTANTLY, THE BENEFIT IS TO U.S. EMPLOYMENT, UNLIKE THE FOREIGN PATENT LICENSE SITUATION GIVEN ABOVE.

THE ARGUMENT CAN BE MADE THAT EVEN UNDER THE PRESENT LAWS AND REGULATIONS SOFTWARE COMPANIES MAY LEGALLY QUALIFY THE EXPORTS OF THEIR SOFTWARE AS PROPER EXPORT PROPERTY. SOME LARGE SOFTWARE COMPANIES APPARENTLY HAVE ALREADY FORMED DISCS. ALSO, MANY COMPUTER COMPANIES WHICH BUNDLE THEIR SOFTWARE WITH THEIR HARDWARE RECEIVE DISC BENEFITS FOR THE "BUNDLED" PRICE, NOT THE HARDWARE PRICE ALONE. HOWEVER, NOT MANY COMPANIES WHICH PRODUCE AND TRANSFER UNBUNDLED SOFTWARE HAVE AVAILED THEMSELVES OF POTENTIAL DISC BENEFITS. THE ARGUMENT THAT THE DISC MAY ALREADY COVER SOFTWARE DERIVES FROM AN ANALYSIS OF THE RELEVANT REGULATIONS. REGULATION 1.933-3(F)(3) PROVIDES TWO EXCEPTIONS FROM THE DEFINITIONS OF INTANGIBLE PROPERTY, ONE FOR A COPYRIGHTED ARTICLE WHICH IS A FILM, TAPE, RECORD OR SIMILAR REPRODUCTION. MOST COMPUTER SOFTWARE PROGRAMS ARE USUALLY EMBODIED EITHER ON A TAPE OR A FLOPPY DISC AND THUS ARGUABLY A "RECORD." ALSO, THE REGULATION STATES THAT A COPYRIGHTED BOOK, IF THERE ARE RESTRICTIONS ON COPYING, AND A LICENSE FOR A

MASTER RECORDING TAPE FOR REPRODUCTION OUTSIDE THE UNITED STATES ARE CONSIDERED EXPORT PROPERTY. SOFTWARE PROGRAMS ARE USUALLY PROTECTED BY COPYRIGHT AND ARE LICENSED; THESE LICENSES ALMOST ALWAYS INCLUDE PROHIBITIONS ON MAKING COPIES. WITH SOME SOFTWARE COMPANIES, A SOFTWARE PROGRAM IS PRODUCED IN THE UNITED STATES AND A MASTER TAPE OR DISC IS SENT ABROAD FOR STRICTLY CONTROLLED REPRODUCTION AND DISTRIBUTION. SOMEWHAT CLEARLY, THEN, AN EXPORT OF SOFTWARE PROGRAMS SOULD QUALIFY FOR DISC BENEFITS IF THE OTHER REQUIREMENTS FOR A DISC ARE MET.

HOWEVER, A FINAL PROBLEM IN THIS AREA IS THAT THE INTERNAL REVERNUE SERVICE HAS MAINTAINED (IN REVENUE PROCEDURE 69-21) THAT UNBUNDLED SOFTWARE IS SPECIFICALLY CHARACTERIZED AS AN INTANGIBLE ASSET. THIS CHARACTERIZATION OF SOFTWARE AS INTANGIBLE IS INCONSISTENT WITH THE GENERAL LEGAL AND TECHNICAL DEFINITIONS OF PRODUCT TANGIBILITY. SPECIFICALLY, IT IS INCONSISTENT WITH FEDERAL TAX COURT CHARACTERIZATIONS OF ANALOGOUS PRODUCTS (THE TEXAS INSTRUMENT CASE [551 F.2D 599]; THE WALT DISNEY PRODUCTIONS CASE [549 F.2D 576]; AND THE BING CROSBY PRODUCTIONS CASE [588 F.2D 1293]). THE FACT THAT THE SERVICE CONSIDERS UNBUNDLED SOFTWARE AS AN INTANGIBLE OBIVIOUSLY CAN CAUSE PROBLEMS FOR THOSE FORTWARE COMPANIES CONSIDERED FORMING A DISC.

PERHAPS PART OF THE UNCERTAINTY IS DUE TO THE FACT THAT THE TIME OF THE DISC'S ENACTMENT, THE "UNBUNDLED" SOFTWARE INDUSTRY WAS SMALL AND CONGRESS COULD NOT HAVE FORESEEN THE EMERGENCE OF THIS IMPORTANT INDUSTRY. TODAY, HOWEVER, THE INDUSTRY IS LARGE AND GROWING FAST, BOTH

HERE AND ABROAD. WHILE A U.S. COMPANY MAY WISH TO RISK CHALLENGE BY THE SERVICE AND FORM A DISC, IT WOULD SEEM TO USE THE BETTER COURSE TO AMEND THE DISC/FSC DEFINITION OF EXPORT PROPERTY TO INCLUDE EXPORTED COMPUTER SOFTWARE PRODUCED IN THE UNITED STATES. THE PRESENT TIME APPEARS THE MOST PROPITIOUS TIME TO MAKE SUCH AMENDMENTS AS NECESSARY TO AFFORD DISC/FSC BENEFITS TO U.S. SOFTWARE COMPANIES.

C. THE $2.5 MILLION CEILING FOR SMALL FSC'S IS INADEQUATE. SBANE FAVORS RAISING THE CEILING FOR SMALL FSC'S GROSS FOREIGN RECEIPTS, AS PROPOSED IN S.1804, FROM $2.5 MILLION TO $10.0 MILLION.

THIS RAISE IN THE CEILING MAKES SENSE BECAUSE IT WOULD TAKE UNDER ITS AEGIS THE MAJORITY OF SMALL COMPANIES PRESENTLY UTILIZING THE DISC. FOR DISC TAX YEAR 1980, DISCs WITH GROSS RECEIPTS UNDER $10 MILLION CONSTITUTED NEARLY 85 PERCENT OF ALL DISC RETURN IN TERMS OF NUMBERS, BUT ONLY ABOUT 10 PERCENT OF TOTAL DISC GROSS RECEIPTS. THE EXTENSION OF THE CEILING FOR SMALL FSC'S TO THE $10 MILLION LEVEL WOULD THUS HAVE A RELATIVELY DE MINIMIS EFFECT ON REVENUE LOSSES, YET WOULD CERTAINLY HAVE A DISPROPORTIONATE POSITIVE EFFECT ON SMALL BUSINESSES. IT SHOULD ALSO MAKE THE FOREIGN INCORPORATION ROUTE MORE ATTRACTIVE TO A GREATER NUMBER OF SMALL COMPANIES.

D. THE INTEREST CHARGE ON SMALL DISC'S SHOULD BE DECREASED. WE NOTE THAT S.1804 PROVIDES, FOR CERTAIN SMALL BUSINESSES, THE SO-CALLED "INTEREST CHARGE" DISC ALTERNATIVE. WHILE

IN THEORY THIS ALTERNATIVE WOULD BENEFIT SMALL COMPANIES BY NOT IMPOSING THE FOREIGN PRESENCE REQUIREMENTS, NEVERTHELESS TYING THE TAX DEFERRAL TO THE PAYMENT OF INTEREST CHARGES ON THE DEFERRED INCOME PEGGED TO THE T-BILL RATE ESSENTIALLY NEGATES MOST OF THE DEFERRAL BENEFIT IN THESE DAYS OF HIGH INTEREST RATES. THE GATT MAY REQUIRE AN INTEREST CHARGE, BUT IT IS MUCH DEBATABLE WHETHER THE INTEREST RATE MUST BE THE (HIGH) INTEREST RATE SOUGHT TO BE IMPOSED UNDER S.1804.

OUR CONTENTION THAT THE PROPOSED FSC LEGISLATION IS LESS THAN IDEAL FOR SMALLER COMPANIES IS BROUGHT OUT BY THE SEPTEMBER 27, 1983 CONGRESSIONAL RESEARCH SERVICE (CRS) REPORT, WHICH STATES THAT "SMALLER EXPORTERS WOULD RECEIVE A SMALLER TAX SAVINGS UNDER FSC THAN THEY CURRENTLY RECEIVE UNDER DISC" (CRS STUDY, AT "ABSTRACT," 28, 29, 31). ON THE OTHER HAND, "FOR MOST LARGER FIRMS THE TAX BENEFIT SHOULD BE APPROXIMATELY THE SAME" (CRS STUDY, AT 24). WHAT WE ASK, THEREFORE, IS THAT AT LEAST SMALLER COMPANIES NOT BE TREATED ANY LESS BENEFICIALLY THAN UNDER PRESENT LAW.

E. JOINT COOPERATION AMONG SMALL COMPANIES MAY BE ESSENTIAL TO THE VIABILITY OF THE FSC FOR THESE COMPANIES.

SBANE FAVORS THE ABILITY OF JOINT PARTICIPATION AMONG SMALL BUSINESSES RELATIVE TO REGISTRATION AND MAINTENANCE OF FOREIGN SALES CORPORATIONS.

THE LEGISLATION SHOULD INCLUDE COMPREHENSIVE ASSURANCES THAT SUCH JOINT PARTICIPATION IS COMPLETELY EXEMPT FROM THE PURVIEW OF THE U.S. ANTITRUST LAWS ALONG THE SAME LINES ESTABLISHED UNDER THE EXPORT TRADING COMPANY ACT OF 1982.

SBANE FAVORS A ROLE AS "VEHICLES FOR FOREIGN INCORPORATION" FOR REGIONALLY ORGANIZED, NON-PROFIT AGENCIES SUCH AS PORT AUTHORITIES, AS DISCUSSED IN THE ORIGINAL ADMINISTRATION PROPOSALS OF MARCH 9, 1983 ON "TAX ALTERNATIVES TO DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)."

IV. SUMMARY

SBANE VIEWS AND WILL FOLLOW THIS LEGISLATION WITH GREAT INTEREST. SBANE FAVORS A BROADENING OF THE ELIGIBILITY CLAUSE, SIMPLE PROVISIONS FOR COMPLIANCE BY SMALL BUSINESS, BROADENING OF COVERAGE TO SOFTWARE AND SERVICE COMPANIES AND SPECIAL TOOLS (JOINT PARTICIPATION AND A ROLE FOR REGIONAL NON-PROFIT AGENCIES) FOR IMPLEMENTATION AND ADMINISTRATION.

SBANE'S BOARD OF DIRECTORS, ITS INTERNATIONAL TRADE COMMITTEE, AS WELL AS INDIVIDUAL MEMBERS, STAND READY, WITHIN THE LIMITS OF THEIR ABILITY, TO PROVIDE YOU WITH ANY ADDITIONAL SUPPORT, COMMENTS, OR FEEDBACK YOU MAY DESIRE ON THE ABOVE SUBJECT.

THANK YOU.

Senator **Danforth**. Obviously, if we are to ward off duties imposed by other countries on U.S. exports, something has to be done with DISC—other than just reenacting DISC. And that something is proposed by the administration. It does impose on U.S. businesses requirements to conduct some activities abroad. Obviously, a large international corporation is presently in a position to conduct activities abroad—the smaller the company, probably, the less likely it is to be able to do that.

Were you encouraged by the testimony of—maybe you weren't here for it—the Assistant Secretary of Commerce, Mr. O'Day, who said that he thought that there was a relationship between this bill and the Export Trading Company Act and that there was a possibility of joint ownership of foreign operations and, further, that the Commerce Department was going to undertake a special effort to try to get out into the country and work with smaller businesses to try to figure out ways of complying with the new law.

Mr. **Roush**. Mr. Chairman, in general, we are encouraged by that. As I mentioned though, I think it needs to be a little better defined, a little better discussed.

Senator **Danforth**. Would you rather discuss that with them and work it out, or would you rather have us resolve the inflexibilities——

Mr. **Roush**. That is why I mentioned legislative history, particularly with that proposal. I think discussing it with them first, yes, which we have been doing, and then to the extent that that is fruitful, perhaps in some of the legislative history, a discussion of it.

Senator **Danforth**. My own view would be to have the most flexibility possible so that the law would be complied with. No doubt about that if we are to give American businesses the opportunity to put together what the Assistant Secretary of Commerce called creative approaches to meeting the objective.

Mr. **Roush**. We certainly support creative approaches to the process. As I understand the export trading company process at the moment, it is just beginning to barely reach small businesses. It is primarily being taken advantage of by larger corporations, and that could perhaps be cited as evidence that they need to do a little bit more in developing that mechanism, particularly as they connect it with this.

Senator **Danforth**. That is interesting to know because the purpose of the Export Trading Company Act was specifically for small- and middle-size businesses.

Mr. **Roush**. That is right.

Senator **Danforth**. And the theory that larger businesses had their own operations. It would seem to me that this is a very close fit—this bill is a very close fit, with export trading companies.

Yes, sir?

Mr. **Mirabito**. Mr. Chairman, I think that it would certainly be important to provide some legislative guidance to the Department of Commerce in that respect. I don't think that is the complete answer to the problem, however, because many small firms that have not been in the export business previously might be well advised to get into it themselves rather than through an export trading company.

Senator **Danforth**. I am glad to hear that from both of you because that bill was largely Senator Heinz' and my effort and I am disappointed to hear that.

Did you have any questions?

Mr. **Mirabito**. I wanted to make one final comment, if I might. Looking at my own testimony and hearing that of others representing small businesses, I think what small business is looking for basically is equality under the FSC legislation similar to that they now have under the DISC legislation.

Senator **Danforth**. Is what?

Mr. **Mirabito**. Equality of treatment. I don't think it exists under the present administration bill. I think that comes out very clearly in the recent Congressional Research study on the FSC.

Senator **Danforth**. Isn't that inherent, though? I mean, we would all like it, but if you are saying you have to do something abroad relating to sales activity, you have to have some kind of representation abroad, that would tend to favor somebody who is now doing business with a sales force abroad.

Mr. **Mirabito**. But I think it is possible to extend the $2.5 million so-called small FSC—as I said earlier—to $10 million or $5 million to include a large number of what one might call small companies, but which in their own rights are actually a little bit larger than small companies.

I think for those companies which choose to go the so-called interest charged DISC route, the present rate of interest which is imposed on the T-bill rate almost negates most of the benefits.

Senator **Danforth**. Yes.

Mr. **Mirabito**. I think that one can lower that rate without offending the GATT.

Senator **Danforth**. OK. We will look at it. I think that the question we are going to have to resolve is what kind of bill is going to be able to meet the challenges—and our purpose, as Ambassador Lighthizer indicated. This isn't going to be rolling over and playing dead. So, we have to meet the objections that were lodged against DISC by enacting something a little bit different than DISC.

Mr. **Roush**. Just adding to that comment, if you don't mind, Mr. Chairman. Our experience with our members is that relatively few—almost minisculely few—of our members were able to avail themselves of DISC and one of the reasons that we have a very general, positive interest in this—even as introduced—is that we think there is potential for more of them to use this mechanism as convoluted as it might appear at first, so that the expanded number of users will more than compensate, hopefully, for any other problem it might have.

Senator **Symms**. Mr. Chairman, can I ask a question on that? Would one of you please explain to me how the present DISC works and with respect to the section on the interest free loan, vis-a-vis the way you project this one will work and why, if under the present language, you can't get the benefit out of what you could under the old DISC?

Mr. **Roush**. As far as explaining how the present DISC works, I can't do that. I would have to submit that in writing, but as far as the commenting on the interest charge DISC, it is my counsel's belief that that will be a very rarely used mechanism by the kind of people we represent, that they would go to the small FSC before they would go to the interest charged DISC.

Senator SYMMS. OK. Do you agree with that?

Mr. MIRABITO. Yes. I agree with that.

Senator SYMMS. OK. That is really what I wanted to hear.

Senator DANFORTH. Do you have any more questions?

Senator SYMMS. No more questions.

Senator DANFORTH. Gentlemen, thank you very much.

Mr. Farrell and Mr. Rasmussen.

Mr. Farrell.

STATEMENT OF EDWARD L. FARRELL, ALEXANDER GRANT & CO., WASHINGTON, D.C.

Mr. FARRELL. Mr. Chairman, my name is Edward L. Farrell, Jr. I am a tax partner with Alexander Grant & Co., which is a member firm of Grant-Thornton International, one of the major public accounting firms of the world.

Preeminent among our clients are many young growing businesses. It is as the professional advisers to this middle market segment of the business community that these comments are addressed today.

I am sure it is not news to anyone here today when it is specifically requested that a focus be placed upon the 20 to 30 percent reduction in benefits offered under the Foreign Sales Corporation, as opposed to the DISC with respect to new and high growth exporters.

But even more importantly, let me state clearly that if a liberal view is not adopted as to what constitutes compliance with respect to the foreign management and economic process requirements, there is no doubt that there will be few if any small and middle market companies which will be able to utilize the foreign sales corporation.

It would seem clear, therefore, that the small foreign sales corporation is the only hope of attempting to address the double albatross of reducing the tax benefits and increasing the costs for the foreign management and economic process requirements. The first task therefore, we believe, is to increase the test level at which the small foreign sales corporation can be fully utilized.

The $2.5 million gross receipts level must be substantially increased and, in addition, in order not to be unfair to low margin exporters, an appropriate alternative nets profits test should be available. Depending on the extent to which the foreign management and economic process requirements are pushed, the threshold level should be increased.

In addition, further consideration should be given to finding ways to enhance the advantage and flexibility of a small foreign sales corporation, such as exempting it from the carrying charge provisions or submitting a sub-S corporation to own a foreign sales corporation.

Our last point I would like to speak on today relates to the burden of proof regarding compliance with the foreign management and economic process requirements, where an affadavit is filed.

The mere shifting of the burden of proof is not enough. There should be a time limit in which the service could challenge the method under which a company—especially a smaller company—is using to comply. I am not referring to the veracity of the statements, but to the method.

In addition, Congress should provide oversight as to the nature of the challenges which the service would be making with these affidavits. Thank you very much for the time today.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Edward L. Farrell, Jr., follows:]

TESTIMONY FOR EXPORT TAX INCENTIVE LEGISLATION PRESENTED BY EDWARD L. FARRELL, JR.

We are pleased to present our comments to the Senate Finance Committee regarding the Foreign Sales Corporation Act of 1983.

Alexander Grant & Company is part of one of the major CPA firms in the world, Grant Thornton International. We have offices in over 60 cities in the U.S. and in more than 60 of the world's major trading countries. Preeminent among our U.S. clients are many young growing businesses which have their own peculiar needs. It is, as the professional advisors to this middle-market segment of the business community, that we address our comments.

Reduction on Benefits for New and High Growth Companies of from 20% to 33%

Too often, the major multinational corporations and their representatives dominate the discussion of vital international trade issues. However, many now realize that if the U.S. is to regain its world-wide competitive position, middle-market companies must also find and exploit world-wide markets for their products. It is critical that their voice be heard and their needs be met. It is with much dismay, therefore, that we approach the major thrust of the proposed Foreign Sales Corporation Act of 1983 (hereafter FSC), i.e., a reduction in tax benefits for new and high growth companies in favor of the established and mature exporters. For these companies the net benefits may very well be from 20% to 33% less than under the current Domestic International Sales Corporation (DISC) rules.

Foreign Management and Economic Process Requirement

If a liberal view is not adopted as to what constitutes compliance with regard to the foreign management and economic process requirements, there is no doubt that there will be few, if any, middle-market companies which will be able to utilize the FSC.

Proposal to Expand the Small FSC

In addition to the reduction in benefits, such middle-market companies will also have to bear the costs of complying with the foreign management and activities requirements. In order to redress this unfortunate situation, it is proposed that the small FSC be amended as follows:

(1) Raise the level of foreign trading gross receipts which may be taken into account by a small FSC from $2.5 million to between $10 million to $20 million, depending on the extent of the foreign presence requirements. In addition, in order not to penalize exporters with low profit margins, it is manditory that there should be an alternative net profits test. These levels should automatically be increased with inflation.

(2) Permit a small FSC to benefit from the graduated rate schedule of Internal Revenue Code Section 11(b).

(3) Direct the Secretary to prescribe regulations permitting a small FSC more liberal rules in determining profits under the marginal costing rules when a small FSC is seeking to establish or maintain a market for export property. For example, for the first five years for which a small FSC exports a product, the no-loss rule could be made inapplicable.

(4) Exempt a small FSC from the "carrying charges" provisions of proposed Section 927(d)(i) at least with respect to sales which by their terms are not due beyond six months.

(5) Permit an "S Corporation" under Internal Revenue Code Section 1361 to own and enjoy the benefits of a small FSC.

(6) Exempt dividends from a small FSC (or a regular FSC) from the personal holding company provisions of Internal Revenue Code Sections 541, etc. The General and Technical Explanation of the Reagan Administration's Proposal for Replacing Domestic International Sales Corporation provides that such dividends will be excluded from "ordinary gross income" for purposes of determining personal holding company income (Item 7 of the Technical Explanation). The draft legislation does not contain such a provision. It is important for many growing businesses to be free from this concern.

The above comments have been directed specifically to the small FSC, which we hope could be expanded so as to be useful to a broad segment of middle-market exporters and prospective exporters, all of whose potential for exporting needs to be guided and harnessed in this critical time.

Foreign Management and Economic Process Requirement

If a liberal view is not adopted as to what constitutes compliance with regard to the foreign management and economic process requirements, there is no doubt that there will be few, if any, middle-market companies which will be able to utilize the FSC.

Burden of Proof Regarding Foreign Management and Economic Process Requirements

The Administration's Technical Explanation (last paragraph of Point 5) provides that if a FSC files an affadavit with the Commissioner in the prescribed form, such FSC "shall be considered to meet the foreign presence requirements." Section 924(f) of the proposed law merely provides that the burden of proof with respect to such issue is upon the Secretary. In order to strengthen this matter, we suggest consideration be given to the following:

(1) The Secretary should be prohibited outright from attacking the method of compliance as outlined in an affadavit

after one year has lapsed from the date it is received by the Secretary.

(2) The Secretary should periodically report back to Congress as to the nature of the challenges it is mounting on the issue of foreign business presence in instances where affadavits have been filed.

Miscellaneous Technical Recommendations

(1) The bill has two sections entitled "Sec. 2."

(2) Non-Foreign Trade Income (FTI) of a FSC (i.e., passive income and carrying charges) will be taxed to the FSC aseffectively connected income and again when distributed to a corporate shareholder and again when distributed to the ultimate individual shareholders. There does not appear to be any reason for such harsh treatment. We suggest that a FSC be exempt from taxation on non-FTI if it distributes same to its shareholders in a taxable distribution. Alternatively, an exemption should be provided when such income already subject to U.S. taxation in the hands of a FSC is distributed.

(3) There should be a mechanism whereby a U.S. controlling shareholder with a net operating loss for a particular year could share or allocate such loss to the FSC. This would prevent an occurrence whereby an FSC pays tax yet the parent has an operating loss for the same period.

Senator DANFORTH. Mr. Rasmussen.

STATEMENT OF THOMAS J. RASMUSSEN, DIRECTOR, DELOITTE HASKINS & SELLS, WASHINGTON, D.C.

Mr. RASMUSSEN. Thank you, Mr. Chairman.

My name is Tom Rasmussen. I am director with Deloitte Haskins & Sells, an international accounting firm. I appreciate the opportunity to appear before you today to comment on this legislation.

My comments are directed at section 2(c) of the bill, which would overturn the currently permissible Federal income tax treatment of international factoring transactions.

Specifically, the bill would amend section 553 of the Internal Revenue Code so that discount income earned by a controlled foreign corporation from accounts receivable purchased from a related person would be included in Subpart F income. The bill would also amend section 956 of the Code to treat a CFC's purchase of receivables from a U.S. person as an investment in U.S. property.

The transaction at which section 2(c) is directed is a common method used by U.S. corporations to factor trade receivables. Congress, when it enacted Subpart F in 1962 and again when it amended it in 1976, was concerned with preventing CFC's from accumulating offshore untaxed passive income and from repatriating cash without tax as a disguised dividend.

The factoring arrangement violates neither of these concerns because the income earned by the CFC is income earned from an active trade of business or factoring, and the purchase of receivables from a U.S. parent corporation is not a dividend, but merely an acceleration of cash that the U.S. company would receive in any event.

These amendments should be deleted from this legislation because they would affect all companies engaged in international factoring, not just Domestic International Sales Corporations or FSC's. Thus, these amendments should be given careful consideration apart from the unique considerations involved in the FSC legislation. Further, we recommend that these amendments not be enacted in any form because they would prevent U.S. companies from effectively managing foreign currency exposure. They would remove an efficient source of funds for U.S. operations. They would encourage the investment of corporate funds overseas, and they would have little, if any, meaningful impact on efforts to reduce the Federal deficit by increasing revenues.

Finally, Senator, if section 2(c) of the bill is enacted, then its effective date should be changed from August 4, 1983 to the date of enactment or later so as not to penalize by retroactive taxation transactions that are completely legal under U.S. tax law. Thank you. sir.

Senator DANFORTH. Thank you, sir.

[The prepared statement of Thomas J. Rasmussen follows:]

Statement of
Thomas J. Rasmussen
On S. 1804, Regarding Federal Tax Treatment of International Factoring Transactions, Before the Senate Committee on Finance

I am Thomas J. Rasmussen, a Director in the National Affairs Office of Deloitte Haskins & Sells, an international accounting firm. I am pleased to have the opportunity to appear before the Committee today to express my views on a proposal which could affect a number of our clients.

The proposed Foreign Sales Corporation (FSC) Act (S. 1804) will, if enacted, replace the existing Domestic International Sales Corporation (DISC) statute with a different set of rules for providing tax benefits to U.S. exporters. The FSC legislation was developed as a result of a dispute between the United States and other signatories of the General Agreement on Tariffs and Trade (GATT), who claim that the DISC is an illegal export subsidy. However, section 2(c) of the FSC proposal goes beyond the context of this dispute to upset the permitted tax treatment of a transaction used by companies to factor or sell their trade receivables to controlled foreign corporations (CFCs). The bill would amend sections 553 and 956 of the Internal Revenue Code to (1) treat discount income of a CFC from accounts receivable purchased from a related person as subpart F income and (2) treat the purchase of the accounts by the CFC from a related U.S. person as an investment in U.S. property.

In our opinion, these proposed amendments have no place in legislation whose purpose is to replace DISC and, in any case, represent an unjustified attempt to penalize a legal and economically valid arrangement that provides important financial benefits to American businesses.

In our testimony we will explain our reasons for disagreeing with the bill's proposed amendments to sections 553 and 956. We will also discuss the nature of the factoring arrangement, its compatibility with U.S. tax principles and the necessity for allowing it to continue.

I. Description of the Factoring Transaction.

The transaction at which section 2(c) is directed is a common method used by U.S. corporations to factor trade receivables. Typically, a U.S. parent corporation with accounts receivable from the sales of its products will sell those receivables to a subsidiary that is a CFC, usually one established in a low tax jurisdiction. The parent sells the receivables at a discount to reflect the subsidiary's assumption of administrative expenses and risk of loss in regard to collection of the receivables. The discounted price of the receivables is the fair market value of the receivables and as such is the same price at which the corporation would sell the receivables to an unrelated party. The subsidiary collects the receivables from the parent's customers and uses the proceeds to purchase additional receivables from the parent. Any risk of loss is born by the subsidiary. Because of the interaction of various provisions of the Internal Revenue Code, this transaction does not result in added tax burdens to the U.S. company or to its CFC.

II. The Effect of the Foreign Sales Corporation Act on the Factoring Transaction.

The proposed legislation will change the current tax treatment of the factoring arrangement in two respects. First, the FSC legislation statute would amend the definition of foreign personal holding income contained in section 553(a) to include "[I]income from an account receivable or evidence of indebtedness arising out of the disposition of property described in section 1221(1), or the performances of services, by a related person . . . ." Thus, the discount income earned by the factoring subsidiary would constitute subpart F income. Second, the FSC legislation would amend section 956 to include the accounts receivable purchased by the subsidiary within the definition of " United States property." Thus, the shareholders of the CFC would be subject to tax on the factoring arrangement if the other requirements of section 956 were met.

III. Reasons Why the FSC Amendments to Sections 553 and 956 Should Not Be Enacted.

A. Legislative Background of Subpart F Legislation.

To understand why the proposed amendments to Subpart F set forth in the FSC legislation should not be enacted it is necessary to recall Congressional intent in drafting subpart F.

Generally, a U.S. corporation is not taxed on the earnings of a foreign subsidiary until the earnings are repatriated in the form of a dividend. In passing the Revenue Act of 1962, Congress concluded that this general rule of deferral of U.S. income tax on earnings of foreign subsidiaries could be abused, especially in situations in which subsidiaries operated in so-called tax havens. Consequently, the Revenue Act of 1962 provided that certain undistributed income of controlled foreign corporations -- subpart F income -- was to be included in the income of U.S. shareholders in the year earned, whether or not distributed as a dividend to the shareholders. Congress also recognized that U.S. shareholders of CFCs might have an incentive to bring the subsidiary's cash back to the U.S. in ways that technically did not constitute a dividend for tax purposes. To thwart such techniques, Congress enacted section 956 as part of the subpart F legislation.

The rationale for section 956 was that the use of untaxed earnings of a CFC to invest in U.S. property was the substantial equivalent of a dividend and should be taxed accordingly. Thus, the investment by a CFC in the stock or debt obligations of a U.S. person was treated as an investment in U.S. property. Nevertheless, Congress recognized from the beginning that some investments in U.S. property by CFCs were not disguised dividends and should be exempted from section 956. Such investments were normal commercial transactions in which there was no intention to make the funds available for an indefinite period to the U.S. shareholders. Thus, section 956(b)(2)(C) permitted CFCs to invest in the obligations of related or unrelated U.S. persons as long as these obligations arose in connection with the sale or processing of property and did not exceed levels that were ordinary and necessary to the trade or business of the parties involved.

In 1976 Congress amended section 956 to narrow the definition of "U.S. property" because of a recognition that the section as it stood was overly broad and discouraged investment in the U.S. Accordingly, Congress added another exception to section 956, permitting a CFC to purchase the stock or debt obligations of unrelated U.S. persons. This exception would permit a CFC that wanted to invest its working capital to do so in the U.S. rather than abroad, thereby reducing the accumulation of funds offshore.

B. Factoring Transaction is Not a Disguised Dividend.

The purchase of a U.S. corporation's accounts receivable by a CFC is not a disguised dividend that Congress sought to prevent by enacting section 956. It must be remembered that the cash transferred to the U.S. company is a payment at fair market value for short term assets. The IRS itself in a recent private letter ruling concluded upon facts typical to these factoring arrangements that a bona fide sale had occurred between the parent and its subsidiary. Such a sale cannot be a dividend because adequate consideration passes between the parties; the parent is not unilaterally enriched by the transfer.

In reality, the CFC and the U.S. company are swapping current assets. The factoring of accounts receivable simply accelerates the receipt of cash by the U.S. company that would have received the cash in due course from the collection of the receivables from third parties. In fact, the U.S. company on its books already accounted for the earnings related to these receivables before it sold them at fair market value to the subsidiary.

The factoring arrangement is clearly distinguishable from an investment in the parent company's stock or debt. Such an investment would provide cash to the U.S. company that it would not have otherwise received in the ordinary operation of its business. On the contrary, a U.S. corporation that factors its receivables to a CFC would eventually have received that cash from its customers who purchased goods on credit. That the U.S. company chooses to generate cash from its receivables earlier than it normally would in no way indicates that the company has received a disguised dividend from its foreign subsidiary.

It must be recognized in the context of the factoring arrangement that the U.S. company and its CFC effect a bona fide sale of the receivables at fair market value and without recourse to the parent corporation. The risk of loss for collection of the receivables is entirely with the CFC. If it is unable to collect from the parent corporation's customers, its earnings, not the parents, are adversely affected. A disguised dividend, on the other hand, means that a non arms-length transaction has occurred between a corporation and its shareholders.

Disguised dividends may be in the form of loans without an intent to create a true debtor-creditor relationship, or bargain sales of corporate property, or excessive payments to shareholders for their property. In transactions that give rise to disguised dividends the corporation makes available to its shareholders cash, property or some other benefit without receiving proper compensation. In the factoring transaction, however, there is a bona fide sale of receivables for cash at an arms-length price. The CFC assumes the risk of loss and the U.S. shareholder, who pays a market price, receives cash from the subsidiary that it would have received sooner or later from customers.

C. Factoring Transaction is Not a Disguised Loan.

The economic reality of the factoring transaction is not the same as that of a loan between a CFC and its parent. A loan by the CFC would provide an additional source of cash to the parent with relatively little given up by the parent in return. In the factoring transaction, there is a bona fide sale of batches of receivables in which the parent gives up its right to collect the receivables and also transfers its risk of loss for failure to collect.

The IRS in its recent private ruling on this issue (PLR 8338043, June 17, 1983) focused its analysis of the distinction between a loan and a sale of receivables on whether the transfer of receivables involved a transfer of the substantial incidents of ownership. The Service listed twelve factors that related to this determination:

1. Which party bears the economic risk of loss inherent in owning the receivables;

2. Who has the absolute power of disposition;

3. Is the transferee entitled to any interest accruing on the receivables;

4. Who is obligated to collect the monthly payments and bear the expenses in connection with their collection;

5. Who is obligated with respect to all property, excise, sales, or similar taxes;

6. Can the transferor hold the transferee harmless from and against any action brought against the transferee which might arise out of the transferor's acting as agent for the transferee in making collections;

7. Are the customers notified of the transfers of their obligations;

8. Does the transferee retain the right to inspect the records and the books of the transferor at any time;

9. Is the servicing of the receivables performed by the transferor and, if so, does the transferee supervise the operation;

10. Does the transferor receive the entire face amount of the receivables transferred;

11. Are all receivables transferred to the transferees;

12. Are any other forms of collateral pledged, such as guarantees, insurance assignments, limitations on payment of dividends, etc.

The Service concluded from the facts presented to it in PLR 8338043, that the transaction constituted a sale not a loan. The facts in this ruling are typical of offshore factoring arrangements. This ruling also implicitly recognizes the economic validity of the offshore factoring arrangement.

Although it is true that private letter rulings are not precedential, there is no question that the Service's analysis of this issue in PLR 8338043 reflects the economic reality of the factoring arrangement and is supported in law. The fact that this transaction occurs between related parties does not alter its substance as a bona fide sale rather than a loan. In fact, the subpart F provisions themselves assume that a bona fide contract for the sale of goods or services may be entered into between a U.S. shareholder and its CFC, in order for the CFC to generate foreign base company sales or services income. Thus, the involvement of related companies in the factoring arrangement in no way indicates that the transaction is anything other than a valid business relationship.

D. The Factoring Arrangement Does Not Violate the Policy Behind Section 956.

By purchasing the accounts receivable of its parent corporation, the CFC simply stands in the shoes of its parent for the collection of the receivables. In the process, the subsidiary allows its parent to use at an earlier point the cash it would have received from customers to carry on its trade or business. Congressional intent in enacting section 956 was not to discourage all investments in the U.S. by foreign corporations but to penalize those transactions that allowed U.S. corporations to have the free use of their subsidiary's accumulated earnings. Even though the factoring operation allows a U.S. corporation to realize cash in its operating cycle at an earlier point than it otherwise would have the factoring operation is neither legally nor economically the type of transaction that Congress sought to prevent in enacting section 956.

Congress emphasized its intent when in 1976 it narrowed the scope of section 956 in order to avoid the unnecessary accumulation of earnings offshore or the investment of CFC earnings in the stock or debt obligations of foreign entities.

> Your committee believes that the present scope of the provision is too broad. In its present form it may, in fact, have a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a foreign corporation looking for a temporary investment for its working capital is, by this provision, induced to purchase foreign rather than U.S. obligations. In your committee's view, a provision which acts to encourage, rather than prevent, the accumulation of funds offshore should be altered to minimize any harmful balance of payments impact while not permitting the U.S. shareholders to use the earnings of controlled foreign corporations without payment of tax. H. Rep. 94-658, 94th Cong., 1st Sess. (Tax Reform Act of 1976).

The factoring arrangement conforms to Congressional intent by bringing cash back to the U.S. to support business operations. Thus, factoring the parent's receivables is not the free use of a foreign subsidiary's earnings that is prohibited by section 956.

E. The Factoring Transaction Does Not Violate the Policy Behind Subpart F as a Whole.

The intent of Congress in enacting Subpart F was to eliminate tax deferral on types of income which are normally susceptible to tax haven arrangements. The intent was not to tax the trade or business income of a corporation carried on entirely in a foreign country. The proposed legislation, however, would subject just such income to taxation.

An offshore receivables company is in the business of factoring receivables. Its primary income is from collecting the receivables at face value after purchasing them at discount. This income arises initially from the ordinary commercial transactions of the U.S. affiliate. The CFC, in purchasing these receivables, stands in its parent's shoes by assuming the risk associated with non-collection of the receivables. There is no guaranteed return to the CFC, and its income is not fixed or determinable as is the case with interest income. Thus, the CFC's discount income is not the type of income that Congress sought to include within Subpart F.

F. There is No Reason to Eliminate Foreign-to-Foreign Factoring.

As discussed previously, one of the changes made by the FSC amendments would be to cause discount income earned by a CFC from accounts receivable purchased from a related person to be included as subpart F income. This change would prevent a CFC from purchasing accounts receivable from its U.S. parent and from related foreign entities. If the intent of the FSC amendments to Subpart F is to prevent tax-free repatriation of earnings, then certainly this change goes beyond even that intent.

By impeding foreign-to-foreign factoring, the FSC legislation would prevent multinational corporations from conducting a rational program of international currency management. Such programs are essential in a world of volatile exchange rates where it is necessary to be able to hedge currency exposure that is a normal part of transactions in a company's receivables.

G. Revenue Effects.

Should the FSC amendments to Subpart F be enacted the factoring of receivables by CFCs would most likely cease but it is incorrect to assume that additional revenue would thereby pour into the U.S. Treasury. On the contrary, foreign subsidiaries would simply continue to accumulate earnings offshore and employ them in foreign investments -- the very result deplored by Congress in the Tax Reform Act of 1976. The only way that U.S. corporations would bring back earnings of foreign subsidiaries would be if such earnings were adequately covered by foreign tax credits. Thus, the U.S. Treasury will gain little if any revenue through the section 956 amendments either because of the deferral of tax on the foreign subsidiary's earnings or because of the operation of the foreign tax credit should such earnings be repatriated. While it is true the proposed taxation of the discount income under Subpart F would bring some revenue, the amount of such income would be so small as to make little difference in the Administration's attempt to reduce the Federal deficit.

IV. Effective Date.

The effective date of the proposed amendments is stated in the bill to be August 4, 1983. There is no justification for threatening perfectly legal transactions with retroactive taxation. If these amendments become law, they should become effective from the date of enactment.

V. Summary.

From the standpoint of legislative history, economic reality, and increasing Federal tax revenues, the FSC amendments to Subpart F make little sense. We therefore strongly urge the Administration to withdraw these amendments and Congress to reject them if not withdrawn from the Foreign Sales Corporation Act.

Senator DANFORTH. Mr. Farrell, have you examined the explanations issued by USTR and Treasury relating to foreign presence requirements?

Mr. FARRELL. Yes, sir. I have briefly reviewed some of those. Yes. But I feel we need more information. I feel we need to know whether short-cut methods are going to be available for complying. I just feel that there is not enough information yet to determine whether or not these are really workable.

They could be very costly. They could be quite easy to comply with. That has still been left in the air.

Senator DANFORTH. OK. Mr. Rasmussen, how do companies treat DISC deferral as an accounting matter? Do they maintain cash reserves?

Mr. RASMUSSEN. It is my understanding, Senator, that some companies maintain reserves for the deferral, and some do not. It has been the position of my firm that we recommend companies to maintain reserves for the DISC's.

Senator DANFORTH. Thank you very much.

[Whereupon, at 11:58 a.m., the hearing was adjourned.]

[The following communications were made a part of the hearing record:]

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Congress of the United States
House of Representatives
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COMMITTEES:
ARMED SERVICES

SUBCOMMITTEES:
MILITARY INSTALLATIONS AND FACILITIES
RESEARCH AND DEVELOPMENT

INTERIOR AND INSULAR AFFAIRS

SUBCOMMITTEES:
CHAIRMAN, INSULAR AFFAIRS
PUBLIC LANDS AND NATIONAL PARKS

November 23, 1983

The Honorable Robert J. Dole
Chairman
Senate Committee on Finance
SD-219
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing to express my support for S. 1804, the "Foreign Sales Corporation Act of 1983," on which your Committee held a hearing on November 18, 1983.

As the Delegate to Congress from the territory of Guam and as Chairman of the House Insular Affairs Subcommittee, I want you to know of my interest in this legislation and my willingness to cooperate in its consideration by the Congress. I understand the original draft bill contained a "tax exchange of information" provision, which was removed before formal introduction of the measure, and that several Members of Congress would like to restore that language. I would support their effort during further congressional action on the bill.

Please let me know if I can provide additional information or assistance to you and your Committee in this regard.

Sincerely yours,

ANTONIO B. WON PAT
Member of Congress

OFFICE OF THE GOVERNOR OF GUAM
WASHINGTON LIAISON OFFICE

RICARDO J. BORDALLO
Governor

EDWARD D. REYES
Lieutenant Governor

BENJAMIN J. F. CRUZ
Director

JESSE P.M. SANTOS
Deputy Director

16 February 1984

The Honorable Robert Dole
Chairman
Senate Finance Committee
Room 221, Senate Dirksen Building
Washington, D.C. 20510

Dear Senator Dole:

The Governor of Guam, the Honorable Ricardo J. Bordallo, has authorized the Washington Liaison Office to submit for the record this letter in support of S. 1804.

Governor Bordallo and the People of Guam endorse the concept of Foreign Sales Corporations and especially the provision that they be incorporated in the possessions of the United States of which Guam is one.

Inasmuch as the underlying purpose of Domestic International Sales Corporations (DISC) and the proposed Foreign Sales Corporations (FSC) is to encourage U.S. exports, the Governor and the People of Guam respectfully recommend that S. 1804 be amended to restrict the situs of incorporation to the possessions. We make this recommendation for reasons that we will now exposit.

I. Tax Haven Problems

A DISC is typically a domestic subsidiary of a U.S. company that is engaged in exporting. Since the "book of account" of both the holding company and the subsidiary are maintained at the home office in one of the states the Internal Revenue Service has ready access to determine the accuracy and veracity of all records.

The U.S. Congress has conducted extensive hearings to determine the revenue losses incurred in tax haven countries throughout the world. The Administration has voiced concern and plans to close these loopholes. Neither effort has been successful.

Allowing the new FSCs to incorporate in *any* foreign country could result in their locating in tax haven countries. The Internal Revenue Service would not be able to determine if the records

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maintained within the United States are the same as the "permanent book of accounts" maintained at the foreign country location. The true income and profits would therefore be difficult to verify.

This problem would not exist if the FSCs were mandated to locate in the U.S. possessions. Despite uninformed and unfounded allegations, the U.S. possessions are not and, in fact and law, cannot be tax havens.

The same Internal Revenue Code and regulations enforced in Kansas, West Virginia and Hawaii are currently and equally enforced in Guam, the U.S. Virgin Islands, American Samoa, and will be applicable in the Commonwealth of the Northern Mariana Islands on January 1, 1985.

The powers of the U.S. Attorney and the U.S. District Courts of Kansas, West Virginia and Hawaii to enforce and subpoena tax and bank records are the same as the powers of the U.S. Attorneys and the U.S. District Courts of Guam, Virgin Islands and the Commonwealth of the Northern Mariana Islands.

The U.S. Banking Codes and Regulations are equally enforceable in Kansas as they are in Guam and the other possessions.

Pursuant to the Supremacy Clause and the Plenary Powers Clause of the U.S. Constitution, unless specifically exempted, the U.S. codes are applicable to the possessions.

The possessions are NOT tax havens. Many foreign countries are tax havens. Failure to restrict the situs of the new FSCs to the possessions could give rise to a new breed of tax haven problems. S. 1804 should therefore be amended to limit the incorporation situs to the U.S. possessions.

II. Balance of Trade

The Congress and the Administration have been complaining about the current imbalance of trade. Authorizing incorporation in any foreign country would further aggravate the problem.

If all the approximately 8,000 DISC are authorized to incorporate in foreign countries rather than the U.S. possessions, the revenue loss in trade and taxes for the U.S. would be substantial when we consider the cost of --

a) office space
b) employees
c) "foreign trading gross receipts"
    1) sale exchange or disposition of export property
    2) "engineering or architectural services for construction projects located outside the United States
d) managerial services
e) meetings of the shareholders and Board outside the United States
    1) travel
    2) hotel and related costs
f) banking services
g) legal and accounting retainers

If the incorporation situs is restricted to the U.S. possessions, all the aforestated costs would inure to U.S. citizens in the possessions which would keep the money within the U.S. system therefore not increasing our trade deficit, while increasing the U.S. tax basis and revenue.

III. Budget Considerations

The President's FY'85 Budget proposal does not provide for capital improvement funds for the possessions of Guam, Virgin Islands and the Commonwealth of the Northern Mariana Islands. American Samoa was allocated a meager $1.6 million.

Previous Executive Budgets have provided anywhere from $30 - $80 million annually in construction grants for the possessions.

The federal deficit issue caused the Administration to zero out any construction grants for the possessions. The possessions are suffering the same type of deficit problems the federal government is experiencing. They therefore cannot afford to underwrite needed infrastructure costs on their own.

The federal government has one of several choices:

1) appropriate for the construction needs of the possessions;

2) allow the possessions to wallow in their problems;

3) pass legislation that would enhance the economy of the possessions thereby encouraging them to become self-sustaining.

The first two options are unacceptable because of the federal deficit and the U.S. image abroad. The third option is therefore the most viable.

Restricting the incorporation situs to the territories would assure the possessions of being the beneficiary of all the expenses and gross receipts listed above.

The possessions would also benefit from the FSCs locating there in a number other ways. The exposure and requirement that certain activities, especially board and shareholders meetings, be held in the possessions would provide the possessions with exposure to corporate heads that it would not otherwise have.

Corporate directors would be made aware of the potential of Guam as the office and financial center for the Asian Pacific region. These directors would see, firsthand, Guam's --

- -- accessibility to markets in the Asian Pacific region
- -- politically stable and receptive business climate
- -- efficient communications systems linking Guam to the United States and Asia
- -- efficient air and water carrier services
- -- lower costs of living than other office centers in Asia
- -- potential as the situs for manufacturing and other corporate related activities.

The same would be true for the other possessions. The end product would be that the economies of the possessions would be enhanced, therby reducing their dependence on handouts in the federal budget, thereby reducing the federal deficit without increasing the foreign trade deficit.

IV. GATT CONFORMITY

The issue of locating in the possessions not conforming to GATT has been raised.

The European community has not indicated full support of the FSC legislation as introduced. Any version passed by the U.S. Congress will probably be challenged. The current DISC system has been in dispute for the last 14 years.

If disputes and challenges are going to be raised anyway, the U.S. Congress might as well make sure that U.S. citizens in the possessions are the beneficiaries of the money spent by U.S. companies in our attempt to satisfy GATT. Foreign countries should not benefit from the new FSC.

The new FSC should encourage the export of U.S. goods and commodities not jobs and money.

The Governor and the People of Guam extend their sincerest "Si Yu'us Ma'ase" for your attention and hopefully your affirmative consideration of this statement.

Respectfully submitted,

BENJAMIN J.F. CRUZ

HENRY J. NOWAK, N.Y.
CHAIRMAN

BUDDY ROEMER, LA.
TOM J. VANDERGRIFF, TEX.
C. ROBIN BRITT, N.C.
DENNIS E. ECKART, OHIO
JAMES R. "JIM" OLIN, VA.

United States House of Representatives
Committee on Small Business
Subcommittee on Tax, Access to
Equity Capital and Business Opportunities
B-363 Rayburn House Office Building
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February 3, 1984

The Honorable Robert Dole
Chairman
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

Today as you discuss the tax proposal to replace the domestic international sales corporation (DISC), I believe there is a need to focus attention on the role of the small business community in our Nation's export picture.

I recognize that the Administration drafted S. 1804 with the objective of meeting the concerns of the General Agreement on Tariffs and Trade (GATT). This is clearly a laudable objective and effort. Nevertheless, the repeal of DISC should not be accomplished at the expense of the small business person. It is essential that we remain cognizant of the fact that small business creates approximately 80 percent of the net new jobs in this country and may well be a tremendous source of new American export opportunities. In fact, according to the United States Commerce Department, there are approximately 20,000 United States firms which possess export potential, but have been unable to participate in foreign trade due to the complexities of initiating an export operation.

In order to encourage a greater small business involvement in the international trade arena, I introduced yesterday the International Trade Tax Act of 1984. This proposal would provide a so-called de minimis rule or safe harbor for small firms. These provisions would not dramatically change the present proposal under consideration other than to provide a small business dimension to this legislation.

This would be accomplished by minimizing the incidences of foreign presence for a small firm. Specifically, a small business would be allowed to exempt some of its international trade income by establishing a subsidiary, known as a "small American international trade corporation" (AITC). Unlike S. 1804, this plan would not require a small business to maintain an office, books or records overseas. In addition, the export subsidiary would not be required to appoint a nonresident director. In order to qualify as a small AITC, the small firm would be required to have under $10 million in average gross receipts and be incorporated overseas, in a United States possession or in a foreign trade zone. In addition to deriving revenues from the sale, exchange or disposition of goods, a small AITC would be allowed to generate foreign trading gross receipts from the performance of services. My proposal would also require the Treasury Department to draft regulations permitting shareholders of an AITC to participate on a joint basis or in a joint trading company venture. Finally, to ensure a smooth transition for small firms which currently operate a DISC, these small businesses would be allowed five years to effectuate compliance with the new export tax measure.

My approach is specifically designed to reduce the complexities of export trading for the small business and to provide a viable incentive for these firms to enter the international marketplace.

In view of the vital role of small business in the job generation process, I strongly urge this panel to give favorable consideration to the unique needs of the small business community in its attempt to capture an equitable share of this Nation's export trade.

Thank you for the opportunity to present my views on this important issue.

With best wishes and kind regards,

Sincerely,

Henry J. Nowak

Henry J. Nowak
Chairman

STATEMENT OF THE HONORABLE FROILAN C. TENORIO
RESIDENT REPRESENTATIVE TO THE UNITED STATES
COMMONWEALTH OF THE NORTHERN MARIANA ISLANDS

BEFORE THE
SENATE COMMITTEE ON FINANCE

IN ITS CONSIDERATION OF
S. 1804 (FOREIGN SALES CORPORATION ACT)

Thank you, Mr. Chairman. I am honored to be afforded this opportunity to present testimony to the Committee on S. 1804, which would permit the establishment of Foreign Sales Corporation (FSC's) in lieu of Domestic International Sales Corporation (DISC's) for special tax treatment on their foreign trade income.

The Commonwealth of the Northern Mariana is in favor of the goals of this legislation. We believe it will benefit American business, improve U.S. relations with its trading partners, and contribute to the economic development of the Northern Marianas and other U.S. territories. I should like to limit my remarks to the application of this legislation to the territories in general and the Northern Marianas in particular.

First of all, the Northern Marianas, along with Guam, American Samoa, and the U.S. Virgin Islands, are outside the customs territory of the United States. Thus, the Northern Marianas qualifies in the bill as an acceptable location for FSC's. This is a very wise approach to take for several reasons. An FSC located in the Northern Marianas or the other territories which qualify has all the advantages of doing its business under the U.S. flag while still receiving favorable tax treatment. It has access to the courts of the United States to enforce its rights in its commercial transactions. The banking, postal, and communication systems are all American. There is assurance of continuity and stability of government and law, and no danger of expropriation or civil unrest. Also, the Northern Marianas and the other territories provide trade and tax incentives to businesses which contribute to their economic development in addition to those which this bill would establish. Foreign locations for FSC's cannot, of course, offer these advantages.

The United States also will benefit when an FSC locates in the Northern Marianas or another territory. The same United States courts which protect the businessman also assure the government that its tax and other laws are fully enforceable. The United States will also be fulfilling to a greater extent its international obligations to promote the economic development of its territories. Not the least effect will be a broader tax base in the territories, an increased shift from public sector to private sector employment, greater fiscal stability, lower unemployment, and a reduced need for Federal subsidies.

For these reasons, the Committee should consider limiting the eligible locations for establishing an FSC to the four U.S. flag territories outside the customs territory of the United States. This will insure against tax haven problems, assure enforcement in Federal courts, avoid the need to consider foreign taxation, and greatly simplify the legislation. This will also more greatly stimulate the economic growth of the territories and reduce their drain on the U.S. Treasury.

Mr. Chairman, the Commonwealth of the Northern Mariana Islands would be proud to provide a home for Foreign Sales Corporations under this bill. I am certain that American businesses will find our islands ideal as the closest location to Japan and the Asian countries, with many local incentives to economic activity, and with the warm "Hafa Adai" spirit with which we welcome all who come to visit or share our place in the sun.

Thank you, Mr. Chairman.

PREPARED STATEMENT

OF

THE AMERICAN ASSOCIATION OF EXPORTERS AND IMPORTERS

FOR

THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

ON

THE FOREIGN SALES CORPORATION ACT (S. 1804)

February 3, 1984

American Association of
Exporters *and*
Importers *11 West 42nd Street, New York, N.Y. 10036 (212) 944-2230*

EXECUTIVE SUMMARY

The American Association of Exporters and Importers (AAEI) strongly supports the concept of the Domestic International Sales Corporation (DISC) and opposes any elimination of its benefits. If an alternative program is needed to meet complaints of U.S. trading partners in the GATT, the substitute should not offer less benefits than are presently available to DISC users.

AAEI supports the Administration's good faith effort to devise a satisfactory alternative which can meet U.S. exporters' needs and resolve the situation in the GATT. However, AAEI believes that the Foreign Sales Corporation (FSC) Act, S. 1804, as it is presently drafted, falls short in a number of areas in meeting the Administration's export promotion goals for the legislation, particularly as regards small and medium-sized exporters.

AAEI recommends that the Committee amend S. 1804 in the following ways to address these apparent deficiencies;

- Expand the "Small FSC" option to allow businesses with up to $10 million in foreign trading gross receipts to take full advantage of this option for a transitional period of five years, during which time the definition of a "Small FSC" would be phased down to $5 million. (This approach would give those small businesses with more than $2.5 million in foreign sales time to comply with the fuller FSC foreign activity requirements.)
- Spell out that the "Interest Charge" DISC option will be made available to companies forming new DISCs after passage of this legislation, as well as to those already established at the time of passage.
- Eliminate the "qualified assets" requirements of the DISC option to permit flexibility in internal allocation of resources which is particularly critical for small exporters and new-to-export firms.
- The relationship between "Joint FSCs" and Commerce Department - certified Export Trading Companies may need clarification if ETC's are expected to organize joint FSCs for other companies. Antitrust protections, now available to ETC shareholders, do not extend to their suppliers. A new certification procedure may need to be drawn up.
- Delete the provisions, in Section 2(c) of S. 1804, which would alter the tax treatment of income earned by a foreign subsidiary which purchases the receivables of a related company such that a U.S. parent company would be taxed currently on its income even if it is not distributed to the parent. ("Factoring" of receivables provides an important source of financing for many domestic and multinational companies. Capital earned by the U.S. parent may be used to finance further exports. As Section 2(c) would make it more difficult for American multinationals to finance U.S. exports, its inclusion is inappropriate in a bill whose overall goal is to promote U.S. exports.)

The American Association of Exporters and Importers (AAEI) welcomes this opportunity to share our concerns about the Administration's proposal to replace the Domestic International Sales Corporation (DISC) Program with a new Foreign Sales Corporation (FSC) Program and to offer recommendations to ensure that any alternative meets the needs of U.S exporters, both large and small.

With 1,400 U.S.-company members nationwide engaged in the export, import and distribution of goods and services worldwide, AAEI is the only organization in the country specifically representing the interests of exporters and importers. Nearly half of AAEI's members are exporters. A large proportion of these exporters are small and medium-sized companies. Still others are just now launching export activities. AAEI believes that the DISC Program provides an important aid to U.S. exporters who must compete in the international marketplace with foreign competitors who enjoy the benefit of taxation systems which are more favorable to exporting than is the American system.

AAEI strongly supports the concept of the DISC and opposes any elimination of its benefits. If an alternative program to the DISC is needed to address objections of our trading partners in the General Agreement on Tariffs and Trade, the substitute should not offer less benefits than are presently available to DISC users.

Whether or not the FSC alternative will be viewed by our trading partners as "GATT-legal" will likely depend as much on political factors as it will on technical features of the program. Given the continuing disputes between the United States and the European Community (EC) about agricultural subsidies, steel imports and other issues, we can envision continued debate about the FSC program. We believe that by comparison with the export incentive programs in some EC countries, the foreign presence requirements in the Administration's proposal are more substantive and more burdensome than might be necessary to meet complaints.

In general, we endorse the government's good faith effort to resolve this international dispute while preserving the benefits of a DISC-like program for U.S. exporters. We urge below, however, that the category of companies that could qualify for exemption from substantial foreign activity requirements be expanded to a broader group of small exporters than is currently proposed.

In introducing S. 1804 (The Foreign Sales Corporation Act of 1983) the Administration stated its intention to maintain the financial incentives of a DISC-like substitute in order to maintain exporter use, to avoid any tax increases for exporters, and to ensure that the FSC would continue to be usable by small businesses in particular.

AAEI fully supports these goals. We are concerned, however, that the legislation as it is presently drafted does not meet all of them as well as it could and must if the replacement of the DISC program with S. 1804 is not to result in less, rather than more, incentive for U.S. exporters to begin or expand their business abroad.

We should like to focus in particular on those areas where we believe the legislation fails to live up to the requirement that small businesses be able to use the program.

The foreign presence requirements pose the greatest obstacles to the program's usability by small companies. As it is now drafted, the small business exception provisions, while headed in the right direction, do not go far enough.

FSC REQUIREMENTS

Organizational and Foreign Presence Requirements

As presently drafted, S. 1804 requires that to qualify for the tax exempt treatment of a part of its foreign trade income, a FSC must:

- be created or organized under the laws of any foreign country or of any U.S. possession;
- maintain an office outside the U.S.;
- maintain a set of permanent books of account at that office (and have these records as well in the U.S.);
- have at least one non-U.S. resident on its Board of Directors; and
- hold all Board and shareholder meetings outside the U.S.

Further, the FSC must perform the following activities (either itself, or through an agent) in connection with any transaction qualifying as a gross receipt. The FSC must:

- participate outside the U.S. in the solicitation (other than advertising), the negotiation, or the making of the contract relating to a transaction; and
- 50 percent or more of the total direct costs incurred by the FSC attributable to a transaction must be incurred for activities performed outside the U.S. (i.e. in foreign direct costs).

Alternatively, a FSC may qualify if 85% of the total direct costs attributable to the transaction are incurred in each of at least two of the following activities:

1. advertising and sales promotion;
2. processing of orders and arrangements for delivery (outside the U.S.) of the export property;
3. transportation from the time of acquisition by the FSC (or the beginning of a commission relationship for such transaction) to the delivery to the customer;
4. determination and transmittal of a final invoice or statement of account and receipt of payment (i.e. billing and collection); and
5. assumption of credit risk.

The key concern that we have with the Administration's proposal, as it relates to both large and small exporters, is the level of foreign activities which a FSC must engage in to qualify for the tax exemptions.

The small business exporter, we believe, will be particularly affected by these requirements. The basic requirement of offshore presence (and its attendant capital outlays) in and of itself poses a real obstacle to small exporters, especially those which have no experience abroad. The long list of further activities (if strictly required) would put the FSC program beyond the reach of a large number of small exporters.

The Small Business Administration has estimated that some 20-30,000 small manufacturers could export but don't, either because they lack information about exporting opportunities and methods or because they are scared off by what appear to be overwhelmingly complex and costly procedures.

If the Administration expects the small business community which uses the DISC to take similar advantage of the FSC (and if it hopes to draw in some of the untapped export potential among the 20-30,000 non-exporters), we believe that the provisions regarding small business exceptions to foreign presence requirements must be clarified, and in some important respects, modified.

SMALL BUSINESS EXCEPTIONS

S. 1804 offers two exceptions from the rules governing FSCs, for small companies: 1) an Interest Charge DISC and 2) Small FSC Provisions.

Interest Charge DISC (Section 2)

This section provides an alternative to the FSC program for businesses with less than $10 million in qualified export receipts. These companies could continue to use their DISCs, and to pay interest (at the Treasury bill rate) on deferred taxes.

The value of tax deferral to any company lies in the use of the money it would have had to pay until such time as the tax is due. For many small companies, paying an interest charge on that deferral could wipe out its value completely. Depending upon the interest rate and the cost of funds to the exporter, the interest charge could exceed the current benefits of DISC in the long run, as deferred income accumulates and interest on that income comes due. However, for some small companies, the availability of any extra capital for export expansion (even for a short period of time) will be welcome.

We believe there is a good deal of confusion within the business community on the question of whether new DISCS, as such, can be formed after the FSC legislation becomes effective. We understand from one of the drafters of the Administration's proposal that the interest charge DISC option is to be made available to new DISCs, as well as to those already established. We urge the Congress to spell out this intention in the FSC legislation.

In order to make the Interest Charge DISC option valuable to small companies, (and particularly these which are new to export), the "qualified assets" requirements of the DISC option (that tax deferred income be invested in qualified export assets) should be eliminated. Companies that are just now launching export activities will need greater flexibility in the use of earned capital (particularly if they must expend some of it on interest payments).

Small FSC Provisions

S. 1804 would permit small businesses with less than $2.5 million in foreign trading gross receipts to use the new FSC provisions if they satisfy the foreign incorporation, office maintance, accounting, and non-resident board member requirements for FSCs. The foreign economic activities requirements would be waived.

AAEI believes that small businesses could meet these requirements (especially if they could jointly maintain foreign offices). The $2.5 million limitation, however, would exclude a large number of small businesses now using DISC.

We support the recommendation, made by the U.S. Chamber of Commerce before this Committee on November 18 of last year, that "the Small FSC option be expanded to allow businesses with up to $10 million in foreign trading gross receipts to be able to use this option for a transitional period of five years during which time the definition of a Small FSC would be phased down to $5 million." This phased-in approach would give those small businesses with more than $2.5 million in foreign gross receipts time to develop the internal structure (and resource allocation) needed to comply with the fuller FSC foreign activity requirements. (The amendment to Section 924 (b)(2)(B) to accomplish this is appended below.)

We believe that raising the limit on the exclusion to $10 million in foreign sales would be insignificant in terms of our trading interests. We note, for example, that in the 1981 DISC year, the DISCs that accounted for nearly 85% of all returns (DISC's with less than $10 million in DISC foreign sales), accounted for only some 8.4% of total DISC gross receipts.[1] Although the benefits in total dollar terms are minimal, we believe the benefit to the U.S. economy in the long run of ensuring the usability of the FSC by these "larger" small businesses is substantial.

Joint FSCs

AAEI appreciates the thinking behind the Administration's joint FSC proposal. While we believe that a joint FSC provision is desirable, we have some questions about the proposal and, more basically, we question the extent to which small companies in particular will indeed make use of this option to satisfy the foreign activities requirements for FSCs. We note a pervasive reluctance among small companies to give up any control of their business to any other company, or indeed to share information and control with other companies. This would appear to be particularly so for companies with little or no experience in foreign business.

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[1] 1981 Annual Report, "The Operation and Effect of the Domestic International Sales Corporation Legislation", the Department of the Treasury, July 1983, Table 4-3 (p. 22).

In fact, at a recent seminar AAEI held on the Essentials of Successful Exporting for Small and Medium-Sized Companies, representatives of highly successful exporting companies counseled would-be, or relatively inexperienced exporters, not to begin exporting through other companies. Specifically urged was personal involvement, full control by top management of all practical and financial exporting decisions, and maintenance of maximum flexibility. A representative of one of the oldest export management companies in the country pointedly noted that new exporters are not good candidates for export management company and export trading company handling of their foreign business. Getting experience for themselves in foreign markets was urged as the first step in taking advantage of export opportunities.

AAEI has in the past consistently supported the efforts of the Administration and the Congress to promote U.S. exports by encouraging the formation of export trading companies. Whether or not ETCs formed under the new certification program of the Commerce and Justice Departments will succeed in bringing small manufacturers into the export sector in large numbers remains to be seen. As yet, the Commerce Department has certified only one ETC proposing to export the products of its small member companies exclusively (U.S. Farm-Raised Fish Trading Company). All other certificates granted to date have been to one or more large companies, which may or may not ultimately aid small companies in exporting.

We would ask, further, for clarification on whether the Administration envisions joint FSCs sharing pricing and other information which activity could raise antitrust liabilities for them. If so, does the Administration contemplate seeking passage of legislation (or amendment of S. 1804) to provide protection to joint FSCs similar to that offered by ETC certification under the Export Trading Company Act of 1982?

We have raised these questions with the Office of the U.S. Trade Representative and with the Office of Trading Company Affairs in the Department of Commerce. We understand that, although not specifically focussed on, the Administration starts from the premise that joint FSCs will not be considered "non-competitive per se". While we welcome this attitude, we believe some specific language in the statute to this effect would be more reassuring to exporters contemplating forming joint FSCs.

We understand also that the Administration expects that companies which plan to form a joint FSC, and which anticipate or fear antitrust liability, will go to the Commerce Department for an ETC certificate. Counsel in the Office of Trading Company Affairs reported to us that that office has not been asked to, nor has it looked in any depth into the relationship between ETCs and FSCs. The Department does not know how a certificate might differ for FSC collaboration (as versus more extensive sharing of information entailed by fuller export trading company activities).

We wonder how the certification process might work for a trading company applicant proposing to administer a FSC for some of its members and to conduct export trading company operations for other suppliers who are not in the FSC. Under the terms of S.1804, would the ETC itself become a member of the joint FSC? The Commerce Department has acknowledged that as the ETC certificate is now designed the antitrust protection that it confers is limited to the shareholders of the incorporated ETC itself -- i.e. the protection does not extend to any activities of the individual companies (suppliers) which a certified ETC may be serving, or from which it may be taking title to goods.

We believe that the Administration may view the new joint FSC concept as one way to spur participation of smaller companies in export trading companies. If it is to accomplish this, we believe that S. 1804 should spell out this practical option and address the provision of antitrust protection for individual companies which form a FSC within the framework of an export trading company. This will be particularly important for the vast majority of smaller companies which are not moving to join as shareholders with other companies to form a full-fledged ETC but which are expressing an interest in making use of others' ETCs to expand their export business.

In sum, we believe that expectations of extensive use of joint FSCs by small businesses may be unrealistic (except for the purposes of satisfying foreign office requirements under the small business exception option). Raising the level of participation in single small FSCs (which can qualify for the exemption from foreign activity requirements) to $10 million in foreign trading gross receipts will do more to encourage small companies to export than might an opportunity to jointly undertake extensive foreign activities.

Income from Trade Receivables of Related Persons

The factoring of receivables provides an important source of financing for many domestic and multinational corporations. The capital earned by the U.S. parent may be used to finance further exports. Section 2(c) of S. 1804 would alter the tax treatment of income earned by a foreign subsidiary which purchases receivables of a related company such that a U.S. parent company would be taxed currently on its income even if it is not distributed to the parent.

Realistically speaking, the dollar contribution of large enterprises to the U.S. export effort (and to the U.S. balance of trade) far exceeds that of small companies (the "potential" thousands notwithstanding). By making it more difficult for American multinationals to finance U.S. exports, AAEI believes that the adoption of this provision is clearly antithetical to the overall goal of promoting U.S. exports which S. 1804 is intended to further.

One further aspect of Section 2(c) which we find disturbing is that the provision as now written is to go into effect on August 4, 1983 (the date on which the bill was introduced). As a matter of practical business functioning, this retroactive tax provision poses a serious burden for business planners. It unfairly penalizes the vast majority of tax payers who do not become aware of proposed changes in tax (or other) laws until after a law is enacted. The retroactive provision would put even those companies which do follow legislative proposals closely in the position of having to make business decisions based on a speculative evaluation of whether the legislation will pass in its present form or will be amended. AAEI urges the Congress to avoid adding to the uncertainties that already face U.S. exporters.

Conclusion

As a strong and consistent supporter of an open international trading system and the multilateral agreements which have made it possible, AAEI believes that if a program is to be devised to meet GATT objections, it must be undertaken in good faith. We do not support, as some have suggested, drawing up a FSC program on paper and then not administering it properly. In the long run, such a course would be self-defeating.

In practical terms, we believe that active involvement overseas by new exporters and small exporters struggling to expand their business overseas will be a healthy development. However, AAEI urges the Congress to recognize that even "larger" small exporters will be denied the maximum help they need in financing their exports if the substitute program does not ease their transition into substantial foreign operations over time.

AAEI believes that any substitute for the DISC should not reduce the benefits that the DISC has provided to U.S. exporters. AAEI stands ready to help this Committee in any way we can to draw up a realistic, and satisfactory, DISC substitute which will give U.S. exporters the tools they need to remain competitive and expand their business in the international marketplace.

Appendix

Amendment to Small FSC Provision of S. 1804

Amend Section 924(b)(2)(B) to read:

(i) In general -- any foreign trading gross receipts of a small FSC for the taxable year which exceed $5,000,000 shall not be taken into account in determining the exempt foreign trade income of such corporation and shall not be taken into account under any other provisions of this subpart.

Add new section 924(b)(2)(B)(v):

(v) Phase-in of limitation --

If the taxable year begins in calendar year	Subsection (i) shall be applied by substituting for "$2,500,000" the following amount:
1984	$10,000,000
1985	9,000,000
1986	8,000,000
1987	7,000,000
1988	6,000,000

Statement of
Rochester Tax Council
Before the Committee on Finance
Hearings on S.1804 -
Foreign Sales Corporation Act of 1983
Friday, November 18, 1983

In lieu of oral testimony, the Rochester Tax Council appreciates this opportunity to submit a brief written statement of its position and comments with regard to S.1804, the Foreign Sales Corporation Act of 1983. The Rochester Tax Council is an organization of major companies that have strong affiliations with the Rochester, New York area. The Council has regularly taken an active interest in corporation tax policy issues, particularly those relating to international business. The Council's members are:

Bausch & Lomb, Inc.
Champion Products
Gannett Co., Inc.
Garlock, Inc.
Gleason Works Company
Eastman Kodak Company
The R. T. French Company
Schlegel Corporation
Security New York State Corporation

Sybron Corporation
Xerox Corporation

Members of the Rochester Tax Council are strong supporters of free and open international trade and consequently support the General Agreement on Tariffs and trade (GATT). Consistent with this support of foreign trade, we took an active role in the enactment of the Domestic International Sales Corporation (DISC) legislation in 1971 and have continued to endorse and support DISC legislation. We believe that exports of American goods have been encouraged by this legislation in a way that balances exporting incentives of other countries and generally promotes free trade. Consequently, we believe that the position taken by GATT with respect to the United States DISC legislation is unfair and inappropriate. Nevertheless, we are prepared to accept the reality of the GATT decision and the United States' commitment to propose a legislative alternative to DISC.

Any alternative to DISC should be premised on the fact that the DISC legislation has provided a practical and simple mechanism to encourage exports of American products. In our statement to this committee on April 20, 1976, we reported the results of a statistical analysis made by members of the Rochester Tax Council for the period 1971 through 1975. The results of this study, based on the reports of the industrial corporations included in our Council, showed that exports had increased from $549.7 million to $1,085 billion, an increase of more than 97 percent. As of 1972 approximately 19,400, or 12 percent of the approximately 161,300 individuals employed by industrial members of the Council were engaged in manufacturing or sales jobs which were sustained by export sales of these member corporations. In 1975 approximately 26,100, or 14.5 percent of the approximately 180,100 individuals employed by industrial members were engaged in manufacturing or sales jobs sustained by reason of export sales. Thus, between 1972 and 1975 export related jobs in the Rochester area increased by more than 34 percent. This dramatic increase in the number of employees engaged in export related jobs resulted from a large increase in export sales as opposed to domestic sales during the period. During this period export sales increase by 69 percent, whereas domestic sales increased by 36 percent only. While we have not completed our new study to update this information, the information from one of our larger members concludes that in 1982 28 percent of its United States employment is sustained by export sales. As noted above in 1975, Council members generally had 14.5 percent of its employees in export related jobs. Thus, we believe that the efficacy of the DISC legislation in promoting exports has continued to be dramatically illustrated by the actual experience of the members of the Council. Therefore, based on our own practical experience as well as the broader studies that have been completed by others, we believe that goals of the present DISC legislation must be continued by some means that is both practical and cost efficient.

We support S.1804 because we believe that it can accomplish the goals that are presently being accomplished by the existing DISC legislation. Our representative has worked for many months as part of the business group that has met frequently with the Office of the United States Trade Representative and the Treasury Department. These meetings have been most constructive and we wish to express our appreciation to the Office of the United States Trade Representative and the Treasury Department for the constructive responses that they have given to suggestions from this business group. We believe that this exchange of views has accomplished much which is reflected in S.1804 in developing a proposal that is not only intended to continue the policy goals of existing DISC legislation but is also intended to do so through a means that is both practical and cost efficient.

There are, however, some important points that need to be clarified before we can feel comfortable that the Foreign Sales Corporation (FSC) is a practical, cost efficient alternative to DISC. These issues include the following:

1. the Office of the United States Trade Representative and the Treasury Department in meetings with the ad hoc business group have developed a draft working paper which clarifies the foreign presence requirements under proposed sections 924 and 925. This draft, after appropriate refinement, should be included in the legislative history of S.1804.

2. S.1804, and in particular the background material developed by the Treasury Department and the Office of the United States Trade Representative, are almost exclusively based on the assumption of an FSC that will buy export products from a related supplier and then resell these products. However, most DISCs operate as commission agents for related suppliers and it is broadly anticipated that most FSCs will also operate as commission agents. Consequently, we consider it quite important that your staffs, in association with the Treasury Department and interested business groups, reevaluate the provisions of S.1804 in general, and section 924(e) in particular, to confirm the need for, and the efficacy of, the requirements of section 924(e) in the case of a commission FSC.

3. Most of the attention in the development of S.1804 seems to have been either on very large multinationals or small businesses that qualify for the small FSC definition of section 922(b). More attention needs to be given to problems of medium size companies such as several of the members of the Rochester Tax Council who do not qualify as small FSCs, but who cannot afford to employ additional persons in the Virgin Islands or other areas remote from their business operations to take on administrative burdens added by this legislation. This legislation should operate in a manner that will not impose new obstacles or significant costs on American companies exporting abroad.

4. While we take no position on the merits of the proposal, we believe that section 1(c) of the Act (dealing with treatment of certain trade receivables) is unrelated to this important legislation and can only complicate and obstruct this legislation. If it is deemed appropriate to make legislative changes with respect to the treatment of such trade receivables, it should be handled as separate legislation or as part of an omnibus tax bill.

In summary, subject to the specific points noted in the preceding paragraph, we endorse and support S.1804. We look forward to working with your staffs and in continuing to work with the Treasury Department and the United States Trade Representative in clarifying and improving this legislative proposal.

STATEMENT OF
WILLIAM B. MODAHL
MANAGER, TAX AFFAIRS
DIGITAL EQUIPMENT CORPORATION
on behalf of
THE NATIONAL FOREIGN TRADE COUNCIL, INC.
on S. 1804
THE FOREIGN SALES CORPORATION ACT
before the
SENATE FINANCE COMMITTEE

FEBRUARY 3, 1984

My name is William B. Modahl. I appear on behalf of the National Foreign Trade Council as a member of its Tax Committee. I am Manager, Tax Affairs for Digital Equipment Corporation, the world's second largest computer company. The Council is a private, non-profit organization which represents more than 600 companies engaged in international trade and investment. The Council supports S. 1804 as a framework for the resolution of certain questions that have arisen with respect to the DISC provisions of the tax law.

The Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code were enacted in 1971 to enhance the competitiveness of U.S. exporters. While DISC has succeeded in improving U.S. competitiveness, it has also been a source of controversy since its enactment. In particular, DISC has been challenged as an export subsidy that is inconsistent with the General Agreement on Tariffs and Trade (GATT), to which the U.S. is a signatory. Although the United States has never conceded the question of whether DISC is consistent with our GATT obligations, the U.S. Trade Representative has assured the GATT Council that the administration would propose legislation to "address the concerns" of the complaining GATT members. S. 1804, the Foreign Sales Corporation Act, is the product of that promise.

In order to address the diplomatic problems raised by our trading partners, the NFTC supports the effort to enact a more clearly GATT-consistent substitute. Of course, any final substitute must perform the same function as that performed by the current DISC; i.e., to partially restore the competitive balance that is upset by foreign tax practices. To be effective, any substitute should give U.S. exporters at least the same level of benefit as that which currently comes from DISC.

DISC and Exports

DISC has been very successful at encouraging U.S. exports. In its 1983 report on the 1981 DISC year, the Treasury concluded that DISC accounted for increased exports of $7.2-$11.0 billion that year. In addition, a recent Price Waterhouse study has suggested that this increase in exports may generate sufficient economic activity to result in a net revenue gain from DISC. The number of DISCs has grown dramatically from about 3,500 in 1972 to more than 17,000 in 1983.

At Digital almost 40 percent of our sales are overseas. Our international business has helped us to achieve global economies of scale necessary to being competitive at home and abroad. For example, without this volume, we would be severely limited in our ability to finance our increasing levels of R&D. DISC has helped expand exports at Digital. By making such sales incrementally more profitable, it gives managers an incentive to make the extra effort needed to sell overseas. Digital's experience is not an uncommon one. Rather, it is a real-life case that supports the Treasury's overall view of the relationship of DISC to high technology manufacturers. As the

Treasury's 1981 Annual Report demonstrates, high technology exports are quite sensitive to changes in DISC treatment.

Exports and U.S. Jobs

A recent report from the Commerce Department's Office of Trade and Investment Analysis demonstrates that the link between U.S. export performance and U.S. employment is far greater than generally understood. For example, export-related jobs account for one in eight manufacturing jobs and one in six jobs in non-manufactured goods. From 1977-1980 export related job growth accounted for 30 percent of all private sector growth. The drop in exports from 1980-1982 accounted for 40 percent of the increase in U.S. unemployment. Based on Commerce Department and Treasury figures, in 1981 DISC accounted for approximately a quarter of a million jobs for Americans.

With this close relationship of jobs and exports in mind, the precipitous decline in the U.S. trade position is disturbing. The NFTC's Balance of Payments Committee estimates that the merchandise trade deficit will be $59 billion for 1983 and $100 billion for 1984. The Commerce Department has described the drop in U.S. exports as "catastrophic," and has suggested that the optimistic estimates of robust economic growth have overlooked this effect. It is a matter of high national priority to expand exports. The role that DISC has played in supporting exports and export related employment argues strongly for the continuation or expansion of the current level of benefits for exports. Any DISC substitute should preserve these benefits and should be designed so as to minimize the need to create jobs outside the U.S.

DISC and Foreign Tax Practices

Among the reasons American exporters have difficulty meeting foreign competition are the tax and non-tax export subsidies employed by our trading competitors. Practices such as direct agricultural subsidies and industrial targeting policies can give foreign competitors an unfair advantage over U.S. exporters. Further, foreign governments provide both explicit and subtle tax policies that provide special advantages to their exporters. Unfortunately, many of these practices are either not covered under the GATT rules, or are expressly permitted as exceptions to those rules.

For example, some countries have adopted a "territorial" taxing concept under which a nation does not generally tax the foreign source income of their companies. To the extent export sales generate foreign source income, these companies pay little or no home country tax. By contrast, U.S. companies pay a U.S. federal tax of up to 46 percent on export income.

Another tax advantage many foreign competitors hold is their governments' heavy reliance on national sales taxes or value-added taxes. These taxes are generally rebated on export sales, and, consequently, there is no domestic tax burden imposed on products destined for export.

Finally, in my experience, foreign tax officials, as a matter of export policy, frequently do not rigorously examine the export-related transactions of their nationals. By contrast the U.S. zealously enforces the arm's-length standard for transactions among related parties. While the NFTC does not mean to suggest that U.S. tax administrators should depart from their high standards, it is important to recognize the realities of the marketplace.

Congress enacted the DISC legislation in 1971 to offset, at least in part, these foreign tax advantages. In the current parlance, the effort was made toward "leveling the playing field."

S. 1804, Foreign Sales Corporation

In considering the merits of S. 1804, one must recognize the groundrules for its construction. To satisfy our trading partners, the legislation must be consistent with GATT. Because of the federal budget deficit, the legislation must be revenue neutral. If these limits were not essential, the Council would prefer an expansion of the existing benefits to both present users and the services sector of the economy. Nonetheless, under these constraints, S. 1804 provides a reasonable framework for a DISC replacement.

DISC and GATT

The consistency of the DISC with the GATT rule has been challenged since the DISC was adopted in 1971. Arguing that the GATT rules permit the rebate of indirect taxes (e.g., sales taxes and value-added taxes), but not direct taxes (e.g., income and payroll taxes), the European Communities and others sought, and in 1976 obtained, a GATT panel ruling against the DISC. The United States responded by challenging the tax practices of France, Belgium and the Netherlands under which foreign subsidiaries are not generally taxed on foreign source income. The United States was also successful in obtaining a favorable GATT panel ruling against the three "territorial" tax practices.

These disputes have been linked procedurally since 1976. The United States took the position that the GATT panel report on DISC should not be adopted by the GATT Council, thereby making it a binding GATT ruling, unless the GATT Council adopted the reports on France, Belgium and the Netherlands.

On December 1, 1981 the GATT Council adopted all four of the panel reports. Along with these reports, however, the GATT Council also adopted a set of principles that have collectively become known as the "qualifier." The effect of the qualifier was to permit the continued use of territorial taxing concepts.

Under the rules of the qualifier, if arm's-length pricing is observed, there is no obligation to tax economic processes that take place beyond a country's territorial limits. In addition, the qualifier expressly acknowledged that any country may adopt methods to reduce international double taxation.

The qualifier set the groundrules for a DISC replacement. Consequently, the proposed legislation permits a reduction of tax only with respect to income derived from economic processes outside the territorial limits of the U.S. Since the qualifier expressly permits methods designed to reduce international double taxation, the tax benefit is an exemption from tax, rather than the challenged tax deferral method of DISC.

The FSC legislation relies upon the rules of section 482 of the Internal Revenue Code for the determination of what income is earned by the FSC. However, for administrative convenience, taxpayers are permitted to rely upon the performance of certain activities outside the U.S. to qualify for the assignment of a prescribed amount of income. A portion of the income earned under the administrative rules is deemed to be U.S. source and a portion is foreign source. Subject to certain limits, the foreign source income is exempt from U.S. taxation.

Although the legislation includes the possibility of a commission relationship between FSC and its related supplier, it is not clear how a commission agent would qualify under the administrative convenience rules. These presence tests need comprehensive clarification.

In addition to the foregoing general observations on the legislation, a number of technical tax issues has arisen. The following are the major ones:

1. Determination of Source For Non-Exempt Foreign Trade Income (FTI). Under S. 1804 only a portion of FTI would be exempt. The remainder, non-exempt FTI, would be currently taxed and treated as U.S. source income. The automatic characterization of this income as U.S. source may adversely affect some taxpayers. The source of this income should be determined under the general provisions of the Internal Revenue Code.

2. Foreign Tax Credit With Respect to Non-Exempt FTI. It appears that no foreign tax credit will be available for any FTI. While we can understand the reason for denying the foreign tax credit for exempt income, to the extent non-exempt FTI is subject to a creditable foreign tax, the foreign tax credit should be allowed.

3. Other Tax Credits. Proposed IRC section 921(c) would deny FSCs a number of tax credits, including the investment tax credit. We see no reason for the denial of credits that are properly apportioned to FTI that is not exempt.

4. Factoring. Section (c) of the bill would adversely affect the factoring of trade receivables and is generally unrelated to the FSC issue. This is a highly technical, complex issue. The factoring issue should be carefully considered for its negative effects on wholly appropriate business practices. These non-tax motivated transactions include factoring receivables of a manufacturing affiliate to a financing affiliate within the same foreign country, or factoring for the purpose of centralization of currency fluctuation risks. Since the question of factoring has no bearing whatsoever on the FSC issue, any changes should be considered separately.

5. Cliff on Disqualification. In order to use the administrative convenience rules, a taxpayer must perform 50 percent or 85 percent of certain direct costs. We are disturbed about the prospect that a taxpayer might inadvertently miss the qualification by perhaps a fraction of a percentage point. Rather than a complete denial of benefits, consideration should be given to a procedure that would allow a proportionate reduction of tax benefit in the event a taxpayer fails to meet the prescribed percentage levels.

6. Transition Rules. Special care must be taken to assure that any transition from a DISC system to a FSC system is a smooth one. In particular, all DISCs should not be required to meet the export assets test of § 992 as of the same date. Further, DISC benefits should be continued for those long term contracts entered into prior to enactment of this legislation.

In conclusion, the Council supports S. 1804 as a framework for the resolution of the trade related disputes that have arisen under DISC.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
to the
Senate Committee on Finance
Concerning S. 1804,
"Foreign Sales Corporation Act of 1983"

Presented by
Charles W. Stewart, President
November 18, 1983

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
to the
Senate Committee on Finance
Concerning S. 1804,
"Foreign Sales Corporation Act of 1983"

Summary of Principal Points

Subject to certain procedural objections and based on our understanding that normalcy in GATT deliberations will be unattainable for U.S. trade negotiators while DISC remains in effect, we endorse the conversion of the DISC export tax incentive to a FSC-type mechanism using a territorial concept of taxing jurisdiction. In our opinion, the FSC legislation, S. 1804, should conform to the following principles and objectives:

1. A U.S. export tax incentive continues to be a necessary part of our foreign trade policy, and it should operate as a territorial jurisdiction exception to our existing federal income tax if our purpose is to respond to GATT complaints about DISC.
2. All accumulated DISC deferrals must be deemed previously taxed and not subject to further taxation.
3. The FSC should be designed to provide an export tax incentive equivalent in scope and effect to the tax concessions for export activity generally made available by the governments of our major trading partners to their taxpayers.
4. FSC should be made as simple to use as possible, consistent with recognized standards of GATT-compatiblility, and small business "relief" provisions should be made as liberal as GATT standards and revenue constraints will permit.
5. Careful attention should be given to the DISC-FSC transition so that DISC activities can be concluded in an orderly manner and FSC

operations can be commenced without loss of intended benefits for affected parties and transactions.

6. In view of the degree of urgency assigned to this matter by the U.S. Trade Representative, Congress should act on the proposal in the Second Session of the current Congress.

For technical comments and recommendations beyond the scope of this summary, please refer to the main body of the MAPI statement.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

S. 1804: Public Hearings on Proposed Foreign Sales Corporation Replacement for Domestic International Sales Corporation Export Tax Incentive

Introduction

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present its views to the Senate Committee on Finance concerning S. 1804 to establish a Foreign Sales Corporation (FSC) replacement for the existing Domestic International Sales Corporation (DISC) export tax incentive. We request that our statement, including the summary of principal points, attached, be included in full text in the record of this public hearing.

MAPI's Interest

As the Committee may know, MAPI is the national organization, research arm, and advocate for the capital goods and allied product industries in the United States. The industries in question are among the largest exporters in this country and, as a consequence, MAPI has a direct and immediate interest in the subject of the current proceeding. It may be recalled that we vigorously supported the establishment of DISC as part of the Revenue Act of 1971 to restore some measure of balance to U.S. government participation as compared to other countries' participation in the encouragement of export activities. Similarly, we have defended DISC as a viable and vital mechanism of U.S. export policy, and a positive factor influencing our balance of trade and payments, national income, and U.S. employment whenever it has come under question here by persons unfamiliar with its purposes and beneficial effects.

Some Reasons for the Bill

We now find ourselves confronted with a proposal to eliminate DISC and to establish a FSC mechanism in its place because of complaints by certain cosignatories to the General Agreement on Tariffs and Trade (GATT), including several that engage in extensive export subsidization such as necessitated the creation of DISC in the first instance. Further, we are informed that U.S. negotiators have exhausted their remedies—vis-a-vis DISC—for the resolution of disputes within the GATT framework, and that the Office of the U.S. Trade Representative cannot proceed with its program for the dismantlement of tariff and nontariff trade barriers because this country is considered to be in violation of its international obligations as long as DISC continues in effect. More recently, the European Community (EC) has formally demanded that the GATT Council set up a working party to determine the "damages" from DISC to the EC and other signatories, a demand that was rejected pending U.S. congressional progress in bringing DISC into conformity with GATT.

Our Position, in Brief

To summarize our position, we have serious reservations about the handling of the DISC issue in Geneva, including the unilateral concession adverse to U.S. interests, and without congressional and public notification, made on June 8, 1979, by a Treasury Department representative of secondary rank. In our opinion, some representatives of the Executive Branch have either abandoned or have vacillated about DISC, thereby aggravating the impasse in Geneva and prejudging the fate of DISC in the Congress. Having stated this procedural objection and sensing that a restoration of normalcy in GATT deliberations is not attainable for U.S. trade negotiators as long as they remain attached to the DISC "lightning rod," we are prepared to work for enactment of S. 1804 in order to convert the current export tax incentive to a territorial jurisdiction mode of the type used under GATT by certain of our vociferous trading partners.

In that connection, we feel that no reparations for DISC should be owed to the complainants, because neither DISC nor FSC (as conceived) provides levels of export subsidization and/or trade restriction approaching those of our major trading partners. Also, we are fully aware that the conversion of DISC to FSC on a revenue-neutral basis will not necessarily resolve their discontent where they are noncompetitive in certain export markets notwithstanding their subsidization advantages. If we do not maintain that DISC is "legal" under the compact in spite of our conversion to FSC, the other signatories will continue to press for damages. Also, we are aware that if the FSC has no operational substance it will draw criticism. Indeed, even if our export tax incentive were to disappear as an object of controversy, the same countries would continue to protest another domestic tax practice, namely, state taxation of multi-jurisdictional enterprises on a worldwide combined reporting basis, a subject we expect to come before this Committee in the next Congress—if not sooner.

Certain Fundamental Principles

Acknowledging some perceived redundancy to the exercise and the inconvenience of reorganizing, MAPI endorses the DISC-FSC "transformation," subject to our further views set forth below, in order to retain an essential tax incentive and remove an impediment to trade negotiations under GATT. Whereas we have numerous technical observations to make, we believe that the legislation should be shaped in the light of certain fundamental principles, as follows:

1. An export tax incentive continues to be needed and should operate as a territorial jurisdiction exception to our existing system if our objective is to respond to GATT complaints.
2. All accumulated DISC deferrals must be deemed previously taxed and not subject to further taxation.
3. The FSC should be designed to provide an export tax incentive equivalent in scope and effect to the tax relief for export activity generally made available by the governments of our major

trading partners to their taxpayers. "Parity" for U.S. exporters may require some flexibility with respect to the revenue-neutrality of the proposal.

4. The FSC should be made as simple to use as possible, consistent with recognized standards of GATT-compatibility, judged by actual practices rather than abstract notions of compliance, and small business "relief" provisions should be made as liberal as revenue constraints and GATT standards will permit.
5. Careful attention should be given to the DISC-FSC transition so that DISC activities can be concluded in an orderly manner and FSC operations can be taken up without loss of intended benefits for affected parties and transactions.
6. In view of the degree of urgency assigned to this matter by the U.S. Trade Representative, Congress should act on the proposal in the Second Session of the current Congress.

Further general and technical comments are set forth below following a background note.

Background

Policy Considerations

DISC was enacted as part of the Revenue Act of 1971 to help increase the level of U.S. exports and improve the U.S. balance of payments and trade, the latter of which were then more or less continuously in deficit. Considerable concern leading to enactment had to do with export subsidization practices of our major trading partners, particularly those that (1) relied more heavily on value-added taxes than income taxes and applied such value-added taxes to imported goods while rebating the taxes for exported goods, and/or (2) used concepts of territorial jurisdiction that could be particularly advantageous for export operations. Inasmuch as this country had no tax on value added with its built-in export subsidy and already used a worldwide concept of taxing jurisdiction for its income tax, Congress countered with income tax deferral for a portion of export income through the DISC mechanism.

Later, persons who doubted the efficacy of DISC as an incentive and worried about its cost succeeded as part of the Tax Reform Act of 1976 in linking the tax benefit to the annual increase in a firm's export sales. Then, still later, as part of a generalized thrust against tax preferences, Congress reduced the DISC benefit somewhat as part of the Tax Equity and Fiscal Responsibility Act of 1982.

GATT Review of DISC

Meanwhile, our co-signatories to the GATT became perturbed about the DISC because they considered it to be an export subsidy of a type that was illegal under the treaty. In 1972, three EC nations submitted a complaint to the GATT Council, which then convened a panel of experts to study the matter and report on its findings. The United States filed its own grievances against the same three countries, charging that their territorial systems of taxation also constituted illegal export subsidies. The panel of experts reported in 1976 that DISC was in violation of GATT because--as nearly as we can determine--the U.S. firms were not paying interest to the Treasury Department on the deferred taxes and hence were enjoying tax exemption contrary to GATT rules. The European territorial systems were found to be compatible with GATT as long as arm's-length pricing was used.

In 1981, after much time spent by the EC and U.S. "adversaries" in trying to reach a compromise, the GATT Council accepted the panel report subject to understandings that (1) territorial systems would be acceptable with arm's-length pricing; and (2) countries could challenge DISC individually but the United States would maintain its right to defend.

Further Challenges and Then FSC

In mid-1982, DISC was again challenged, this time by Canada and the EC member nations. In October 1982, the Office of the U.S. Trade Representative stated that the Reagan Administration would ask Congress for a GATT-compatible DISC replacement. Subsequently, the Treasury Department was instructed to draft a proposal, the general outline of which was released to the public in March 1983 and a more definitive outline of which was released in June 1983. S. 1804 and its companion bill, H.R. 3810, were introduced in August, and Treasury is now working on--and, at the time of preparation of this statement, has not yet released--a revised technical explanation of its proposal. The FSC proposal is said to be designed to achieve undisputed legality under GATT, and would be revenue-neutral as compared to existing law (including DISC). Unlike DISC, FSC would be foreign-incorporated and would have to meet various requirements of foreign management and foreign economic processes. Also, rather than conferring tax benefit by federal income tax deferral, a FSC would basically derive its benefit from U.S.-foreign tax-rate differentials. A portion of the foreign trading income of a FSC would be exempt from taxation in this country, and the entity could be operated in a buy-sell or commission format.

Qualifying small FSCs would be excused of the foreign presence requirements, and qualifying small DISCs could continue as DISCs subject to interest charges payable to the Treasury Department based on the Treasury bill rate.

The Proposal: In General

We previously mentioned in summary, certain "fundamentals" that either should be reflected in the FSC propsal or, if already present in the Administration's version, should be preserved as the legislation passes through Congress. Some amplification follows.

Territoriality and Incentives

It is apparent from the dialogue that has taken place in Geneva that the expert panels and our trading partners are inclined to construe the Subsidies Code of GATT more in accordance with the letter than the spirit. Therefore, a territorial taxing system can be utilized to allow exporters to divert export income to low-tax jurisdictions, whereas a tax deferral to benefit export income within a system such as the U.S. federal income tax with its worldwide taxing jurisdiction will not be countenanced. The effects of the two approaches might be identical, but one will evidently remain unacceptable. Under these circumstances, and given that the proposed FSC--as already mentioned, is said to have been designed to be GATT-compatible beyond dispute, we agree that the territorial-exception approach is best.

As to the continuing need for an export tax incentive, we think it is essential. DISC was created in response to export tax subsidization and trade restrictive practices that were extensive, and the situation has not abated. Furthermore, we do not subscribe to the view held by some that export tax subsidies are meaningless where currencies are in a floating relationship with one another. It may be true in a theoretically pure float that the surge of exports induced by the incentive would drive up the price of the U.S. dollar in world currency markets thereby offsetting the advantage provided by the incentive in the first instance. However, the only perfect floats that exist are in imperfect models of the global economy. Currency relationships are affected from day to day by central bank intervention and many public- and private-sector interactions that influence the relative values. If the "float" theory had any empirical validity, export incentives would not be used and GATT signatories would not object to DISC.

On the subject of export incentives generally, we should point out that a self-executing tax incentive such as DISC or the proposed FSC is an appropriate and efficient response to the tax incentives employed abroad. At one time, the Treasury staff expressed reluctance about this, suggesting that lower taxes overall or increased Eximbank authorizations might suffice. Treasury has since been disabused of the notion, but we feel compelled to repeat that a few percentage points of reduction in corporate taxes overall would not make up for the specifically targeted incentive of a DISC or FSC. Also, Eximbank financing is neither self-executing nor widely available, even though it is very important in its own right.

Accumulated Deferrals

In changing away from the DISC mode, it is essential that accumulated DISC deferrals be deemed previously taxed and not subject to further taxation. Although the DISC benefit has always been referred to as a "deferral," the predominant view within the independent accounting and corporate taxpayer communities has always been to the effect that the deferral would be permanent. It is only on this basis that the DISC mechanism—intended to place U.S. exporters on a more nearly level playing field with their heavily subsidized foreign competitors—could have had its intended effect. Most U.S.-based companies with DISC subsidiaries have not treated potential DISC taxation as a contingency for which they must accrue. Consequently, taxation of the accumulated deferrals on any basis could have a devastating effect on their financial statements and the markets for their securities, not to mention the unexpected drain on cash flow.

We should add that taxing the accumulated DISC deferrals would be inconsistent with the purpose of continuing the export tax incentive while simply changing it to a GATT-compatible format. Also, there has been no discussion of "retroactively" curbing the DISC incentive, whereas a tax on accumulated deferrals would have that effect. Considering that exporters entered into transactions with certain understandings and expectations regarding the tax effects, a tax on the deferrals at this time would be a most inequitable reversal of the ground rules.

Further, we have every reason to think that a tax on the accumulated deferrals would be contrary to the national interest. For DISC year 1981—ended June 30, 1981, the most recent year for which complete data are available—Treasury estimates that DISC increased exports by $7 to $11 billion over what they would have been without DISC, roughly a 16 percent increase over DISC year 1980./1 This increase in exports induced by DISC means that a very substantial number of domestic jobs were created solely by virtue of the DISC. Inasmuch as nonelectrical machinery, transportation equipment, and chemicals accounted for the largest dollar amounts of DISC income, one can see that important sectors of the economy were buoyed by the export stimulant. Although Treasury's static analysis of revenue impact showed a $1.65 billion loss for DISC year 1981, at least one private-sector organization using more dynamic revenue analysis techniques has concluded in a moderate price response scenario that for every dollar spent on DISC in terms of revenues foregone, the Treasury receives $1.24 in additional revenue collections./2

Obviously, these beneficial effects of DISC would not have been realized to the extent indicated if the DISC incentive had been reduced, and serious hardship would be occasioned by taxing accumulated deferrals after-the-fact. S. 1804 deals with this matter properly, and any efforts to tax the deferrals should be resisted.

1/ "The Operation and Effect of the Domestic International Sales Corporation Legislation—1981 Annual Report," Department of the Treasury, July 1983.

2/ "Economic Impacts of the Domestic International Sales Corporation (DISC) Tax Provisions," Price Waterhouse (Washington, D.C.), April 1982.

Parity

In the best of all worlds, it perhaps would be unnecessary to have countervailing subsidies, countervailing duties, quotas, and the like. Market forces would operate without the interference of tariff and nontariff barriers. Corporations and entire national economies would concentrate on what they do best, and growing economic interdependence would result not only in a more efficient allocation of resources but also in more harmonious relationships among members of the global economy. Of course, we have not yet reached this state of Nirvana, and instead must work through loosely knit confederations like GATT. Where there are trade impediments such as exist with territorial-jurisdiction tax systems that can be designed or used to discriminate in favor of export activity, our response could be to adopt a similar practice (FSC, more or less); adjust strictly within the framework of our existing system (e.g, DISC); respond in some nontax context; do nothing at all; ask our friends to mend their ways; or engage in some combination of the foregoing.

Whatever the approach, we are attempting to eliminate or to some extent neutralize the objectionable activity. In deciding on DISC in the early 1970s and in moving to a FSC now, it has seemed to us that equity for U.S. exporters requires that they be given a substantial incentive equivalent in scope and effect to the tax mechanisms made available by the governments of our major trading partners to their exporters. We recognize that exact parity cannot be achieved, but some approximation of parity should be the objective. Although a revenue-neutral FSC may seem more acceptable in these times of federal budgetary stringency than one that has a major revenue cost, we would remind the Committee that the original DISC was—as indicated in the background, earlier—truncated twice, less for concern about U.S. exports than to satisfy certain revenue projections. Also, as already noted, there is substantial authority for the proposition that DISC did not have any cost to Treasury because of revenue feedbacks.

We simply suggest that the Committee stay flexible about revenue-neutrality, and not allow a preoccupation with such neutrality to prejudge questions that may arise about liberalized definitions, transfer pricing, the determination of exempt foreign trade income, and other characteristics of S. 1804 having cost implications.

Simplicity

The FSC should be made as simple to use as possible, consistent with recognized standards of GATT compatibility in practice, and the small business provisions should be as liberal as revenue constraints and GATT standards will permit. FSC, as proposed, already has certain advantages over DISC in this regard in that there are no qualified assets or receipts tests, no requirements of increases over base periods, and no producer's loan provisions. On the other hand, FSC presents some complications of its own associated with foreign incorporation, management, and economic processes. Accepting that FSC must have some foreign attributes to satisfy our trading partners that we have kept the faith with GATT, we recommend that the Committee require as few as are needed to pass muster under GATT. If Treasury has not done so, it should present information in the public record to show to what extent export marketing companies of territorial-tax jurisdictions respond to GATT requirements of foreign presence and economic substance. Indeed, the Committee may find it feasible to slacken the requirements now contained in S. 1804, especially as to economic processes taking place outside the United States.

Other initiatives also might be considered with a view to simplification. For example, the FSC should be authorized to make very extensive use of agents, related or unrelated and wherever located. Further, perhaps the list of activities relating to the disposition of export property could be made less onerous, or, if that is not feasible, the legislative history could set the stage for liberal construction of the statute. Access to the administrative pricing rules should be facilitated rather than hedged about by onerous preconditions. The FSC should be designed to minimize organizational disruption; fit in with the existing export marketing apparatus (excluding DISC, which is to be terminated in most instances); and be accommodative of normal marketing patterns, typical customer responses, and existing and anticipated order flows. We will return to several of these suggestions presently.

Inasmuch as smaller businesses may find themselves somewhat inconvenienced at the start by the rules of foreign incorporation, management, and economic processes, they should receive special consideration. The provisions for an electing small FSC and an "interest charge DISC" seem entirely appropriate to us, but we do not know how Treasury settled on the $2.5 million and $10 million amounts, respectively, and believe that the "ceilings" could be somewhat higher in deference to smaller firms.

Transitions

Transitions always are a nettlesome part of the tax legislative and regulatory process, and S. 1804 is no exception to the rule. Many taxpayers have commented that S. 1804 does not seem to contemplate an orderly phase-out of DISC activities. Some have estimated that it could take nine months or so to wrap up DISC affairs. Clearly, some time will be needed to introduce the new FSC entity, with its own set of rules and regulations, while unwinding the old DISC operations. Furthermore, the old and new organizations should dovetail so that export transactions that "bridge the gap" in one way or another do not lose eligibility for benefits under one of the two regimes. We specifically request the Committee to address itself to transitions in more detail in either the statute or the Committee report, as appropriate. Moreover, we are inclined to think that the statute, as proposed, itself needs work because of certain impressions conveyed by it.

On a matter of particular concern to manufacturers of machinery, S. 1804 has at least one very distinct transitional "gap" that needs filling. Specifically, a company might solicit export business and then conclude a contract at a much later date because of backlogs, normal delays, and the engineering complexity of unique goods. It will be seen that solicitation is one of the activities that would have to be undertaken by a FSC. With FSC becoming effective on a particular date such as January 1 of the first year beginning after enactment, one could foresee a situation in which solicitation might have occurred before the effective date with respect to a transaction closed after such a date. In the absence of an appropriate transition, it would seem possible that neither DISC nor FSC benefits would be available. We do not believe the sponsors of S. 1804 intended this, and we recommend that attention be given to the omission.

Timing

With the fate of DISC now in question (if not finally determined) due to GATT-related complaints, capitulation by certain Executive Branch personnel, and the sense of urgency transmitted by the Office of the U.S. Trade Representative, an element of uncertainty has been introduced for exporters. A major U.S. foreign-trade policy has been put in question, and should not be allowed to go unanswered any longer than is absolutely necessary. Also, for reasons already noted, we would be most reluctant to have the matter of accumulated DISC deferrals be swept up in the dialogue with respect to federal budgetary deficits that may resume in earnest following the 1984 elections. Either DISC should be left as is--which may no longer be tenable--or the FSC replacement should be installed without ado. Under the circumstances, we feel that congressional action on the matter during the Second Session of the current Congress would be timely and well advised.

Some Specifics

Against the backdrop of the general impressions already stated, we have a number of more specific comments and recommendations to offer, listed in order of general significance.

Economic Processes
(Section 924(d)(1)(A))

The economic processes requirements of FSC are met with respect to the gross receipts of such a company derived from any transaction if, among other things, the FSC (or any person acting under a contract with such corporation) has participated outside the United States in the solicitation (other than advertising), the negotiation, or the making of the contract relating to such transaction.

Comment.--One concern we have with "solicitation" is that an unsolicited order could come to a U.S. related party from a foreign customer under circumstances in which the FSC has not actually "solicited" or "negotiated." This could happen because the customer is unaware that the manufacturer's export business is to be channeled through its FSC as compared to the export marketing organization previously in place. Also, such a bypass would seem particularly likely to occur in the case of follow-on or replenishment orders simply extending business placed at an earlier date. Possibly, the FSC could still "make the contract" under Section 924(d)(1)(A), and the FSC might even meet the 85 percent alternative test if the foreign economic processes requirements are kept flexible. It appears doubtful that the FSC could meet the 50 percent test of Section 924(d)(1)(B).

Whether it is accomplished in the statute or Committee report, Congress should keep the concepts of "solicitation" and "negotiation" fairly flexible so that unsolicited orders of the type just described will not be lost. Indeed, all of the foreign economic process tests should be slack enough to accommodate unanticipated export situations that otherwise would qualify for tax-advantaged treatment.

Foreign Economic Process Percentages (Sections 924(d)(1)(B) and (d)(2))

These sections contain the requirements for performing foreign economic processes so as to have the FSC incur either 50 percent of the foreign direct costs associated with all the specified processes or 85 percent of the foreign direct costs associated with any two of them. The activities in question relating to the disposition of export property are set forth in Section 924(e).

Comment.--Although the tests were worked out by Treasury in fairly close conjunction with outside organizations, including representatives of the business community, there is enough residual complaining about the foreign economic process rules to warrant their review. As a threshold matter, one might ask whether the percentage requirements are not too high. To our knowledge, no information has been given to the public to explain how those percentages were derived. There are any number of ways to ease the requirements, lower percentages being but one, and we believe that the Committee should review and provide information in its report with respect to these determinations.

Agents' Fees (Sections 924(d)(1)(A) and (e))

The foreign economic processes referred to in the sections just noted may be burdensome, and some FSCs will want to have them be performed, to the extent permissible, by agents. The statute does not address the question of fees paid to persons acting on behalf of FSCs.

Comment.--We already have noted that the proposal is not a model of clarity with regard to the extent to which agents may be used by FSCs to meet their foreign economic processes requirements. Clarification is needed, and it is a priority item. Beyond that, information should be provided concerning the fees paid to persons acting on behalf of FSCs. It has occurred to us that, if fees are substantial, they will consume foreign trade income of the FSC, leaving less as exempt amounts. On the other hand, the same result might be occasioned by having the FSC perform the foreign economic processes on its own. Assuming that agency fees would be at arm's-length, would the usual rules apply? Or would it be necessary to have something specific to the FSC context?

Foreign Direct Costs
(Sections 924(d)(3)(B) and (e))

All or some of the Section 924(e) activities must be performed either 50 percent or 85 percent outside the United States, according to the definition of "foreign direct costs."

Comment.--The locus of the Section 924(e) activities will not always be clear. For example, where is advertising "performed" if it is contracted for with a U.K. agency but is "beamed" into the United States, the United Kingdom, and Canada? Where is "arranging for delivery (outside the United States) of the export property" performed if it is contracted for in the United States for delivery outside the United States? Is the "transportation" test met if the FSC or its agent arranges transportation to a foreign destination within the United States? Is the result changed at all if most of the transportation actually occurs in the United States (e.g., a delivery of goods by rail from Seattle to Tijuana)? What is the "location" of the assumption of credit risk?

Again, these matters require attention, either in the statute or the Committee report. We think it is desirable for IRS to have some guidance from Congress for the preparation of its regulations.

Commissions and Economic Processes
(Section 924(d)(4))

Here, the proposal states that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of Sections 924(d) and (e) in the case of commissions, rentals, and the furnishing of services.

Comment.--We question whether everything about a commission FSC should be left to the Secretary as it pertains to economic processes and the disposition of property. Why is the bill written mainly in terms of a buy-sell FSC? As the Committee may know, most companies have commission DISCs and would want commission FSCs because they are easier to use (e.g., no passage of title issues, etc.). The statute provides no guidelines for commission FSCs other than the implicit direction to the Secretary to satisfy the purposes of the provisions as they pertain to buy-sell FSCs. We doubt that Treasury should be left with this much discretion, and suggest that the Committee provide more guidance.

Disposition of Export Property
(Section 924(e))

Various activities relating to the disposition of export property are set forth in the context of the 50 percent and alternative 85 percent foreign activities tests already mentioned.

Comment.--These provisions raise more questions than any others in the proposal. For example, how, if at all, do the five categories of "disposition activities" mentioned in Section 924(e) fit into the three categories of foreign activity (i.e., solicitation, negotiation, or making of the contract) in Section 924(d)? Why is "advertising" mentioned in Section 924(e)(1) when it is excluded from "solicitation" in Section 924(d)(1)(A)? Also, we doubt that all of the disposition activities would fit a commission FSC as compared to a buy-sell FSC.

Similarly, what do various words and phrases mean in Section 924(e)? How does one "process a customer order"? Might one merely send the order by facsimile to the U.S. related party, or is something expected beyond handling? What is contemplated by "transportation from the time of acquisition by the FSC . . . to the delivery to the customer"? How does one "determine" a final invoice? Is "determine" intended to mean "prepare"? What is meant by "assumption of credit risk"? Can a U.S. bank "receive payment" as a collection agent for a FSC, or will that be considered an activity performed inside the United States? We hope that some light will be cast on these matters by Treasury's upcoming revised technical explanation. Certainly, the Committee report should contain further definition, with at least one objective being ease of FSC administration.

Affidavits
(Section 924(f)(1) and (2))

The proposal states that, in any judicial or administrative proceeding involving the issue of whether a FSC meets the requirements of foreign management for a taxable year or a transaction meets the requirements that economic processes take place outside the United States, the burden of proof will be upon the Secretary if a written statement addressing such issue has been filed by an authorized officer of a FSC who is a citizen and resident of the United States. The document in question will have to be a verified written statement made by such officer under penalties of perjury declaring that such corporation meets the requirements of foreign management for the taxable year and specifying how such requirements have been met; or declaring that specified transactions of the corporation for the taxable year meet the requirements of the law and explaining how that has been done.

Comment.—The areas of "foreign management" and "foreign economic processes" could be difficult ones for both administration by the taxpayer and enforcement activity by IRS. The affidavit procedure seems to be a relatively simple way of disposing of the matter, but it also raises questions. For example, what is the obligation and exposure of the FSC officer who signs the affidavit if he does so without complete certainty that his concept of compliance conforms with that of IRS? Does the affidavit procedure relieve the taxpayer in any way of audit on the question of foreign management or foreign economic processes? How will the Secretary carry his burden of proof on the foreign presence issues where he chooses to contest them?

We emphasize that we do not object to the affidavit procedure, but simply would like to know more about it.

Subsidies
(Section 924(g)(1)(B))

Certain receipts will not be included in foreign trading gross receipts, according to the proposal, including receipts of a FSC from a transaction where the transaction is "accomplished by a subsidy granted by the United States or any instrumentality thereof."

Comment.--We realize that the "subsidy" concept has been adopted directly from Code Section 993(a)(2)(B) of DISC, and therefore is not new. However, we would like to know whether the provision would be implemented as it has been under DISC, or whether Treasury has other things in mind. For example, some persons consider tax deductions, exclusions, exemptions, credits, etc., to be subsidies, whatever the purpose. We suggest that the Committee act to prevent Treasury from taking this view of a "subsidized" activity--assuming that there is to be any change from the DISC approach--for purposes of excluding certain amounts from foreign trading gross receipts.

Military Property
(Section 924(g)(2))

This provision would state that the term "foreign trading gross receipts" would not include 50 percent of the gross receipts for the taxable year attributable to the disposition of, or services relating to, military property (within the meaning of Section 995(b)(3)(B)).

Comment.—Although we understand that this military property restriction is already found in DISC, we seriously doubt the wisdom of continuing a 50 percent denial of benefits for military property exports. If a high national priority applies to equipping U.S. allies with the means to resist aggression and if exports of military property increase national income and domestic employment while improving our defense industrial base, why should there have been this discrimination in the first place and why should it be continued now? As the Committee may be aware, U.S. manufacturers of "munitions list" items are in competition with foreign manufacturers of such goods just as much as are manufacturers of other property. The March 1983 outline of the FSC proposal did not contain this exclusion, and, in our opinion, S. 1804 should be purged of it as well.

Commissions, Rentals, Marginal Costing
(Section 925(b)(1) and (2))

The Secretary would be instructed to prescribe regulations setting forth (1) rules which are consistent with the general rules for transfer pricing in the case of commissions, rentals, and other income; and (2) rules for the allocation of expenditures in computing combined taxable income in certain instances where a FSC is seeking to establish or maintain a market for export property.

Comment.--Again, we have a section of the bill that delegates rather considerable authority to the Secretary. The principal of "consistency" with another portion of S. 1804 would apply in formulating regulations for commissions, rentals, and other income. However, there does not appear to be much, if any, direction with regard to marginal costing. If it is desirable to follow the DISC principles in any of these areas left to Treasury, the statute or the legislative history should say so and not leave the matter to Treasury by default.

Administrative Pricing
(Section 925(c)(1) and (2))

The requirements for the use of administrative pricing will be met for a sale by a FSC provided that "all" of the activities of Section 924(e), mentioned earlier, and "all" of the activities of Section 924(d)(1)(a), also stated earlier, have been performed by the FSC or by another person acting under a contract with such FSC.

Comment.—As we read this provision, access to administrative pricing would be much more difficult than the basic test of qualifying for foreign trading gross receipts from a transaction. Specifically, it appears to us that all activities relating to disposition of export property and all activities of solicitation, negotiation, and the making of the contract would have to be satisfied. Also, are we to understand that the 50 percent and alternative 85 percent tests would have no bearing on the question of access to administrative pricing? What consequences would flow from a finding that a FSC had, in fact, not fully complied with the administrative pricing requirements for a transaction where such pricing was applied? Although we realize that arbitrary transfer pricing may be vulnerable to criticism by our GATT friends, we think that it can be made consistent with their standards without putting severe restrictions on its use.

Therefore, we suggest that the Committee simplify access to administrative pricing to broaden the appeal of FSC and lessen the burdens of FSC administration.

Direct Use Outside the United States
(Section 927(a)(1)(D))

The terms "export property" would be construed to mean property that, among other things, is held primarily for sale, lease, or rental in the ordinary course of trade or business by, or to, a FSC, for direct use, consumption, or disposition outside the United States.

Comment.--We understand that DISC law disqualifies a DISC sale from a related manufacturer to a related U.S.-based company with an overseas branch even though the branch receiving the goods then sells from its foreign location to unrelated parties. This type of marketing structure is used by some companies, for example, to lower customs duties into the European Community. Inasmuch as the transactions we are discussing are exports but are following a more complicated pattern of distribution, we request that the Committee consider whether it would be possible for combined taxable income in the FSC context to be defined as the export sales income of all affiliated U.S. companies in an unbroken chain of distribution so that sales of the sort just noted would qualify for tax-advantaged treatment.

Foreign Content
(Section 927(a)(1)(C))

The FSC bill states that export property cannot have more than 50 percent of fair market value attributable to articles imported into the United States, among other criteria.

Comment.--It has come to our attention that a product manufactured for export under the DISC rules would not qualify where it is begun in the United States (e.g., 40 percent value-added), worked on across the border (e.g., another 40 percent value-added), and then finished and tested in the United States (20 percent value-added), prior to export. As we understand the matter, the DISC provisions would treat the export article in this instance as having 80 percent foreign content, even though it does not. Perhaps the FSC bill should indicate that no amount of value-added in the United States would be treated as foreign content.

Excluded Property
(Section 927(a)(2)(B))

Among the categories of excluded property is one covering patents, inventions, models, designs, formulas, or processes whether or not patented, copyrights (with some exceptions), good will, trademarks, trade brands, franchises, or other like property.

Comment.—We are concerned that this provision might be construed to exclude computer software. Either Section 927(a)(1) should make clear that export property includes computer software or Section 927(a)(2) should clarify that computer software is not excluded. Treating the subject matter as "included" property would be preferable.

Related Persons (Section 927(e)(1))

This item would state that, under regulations, the income of a person described in Section 482 from a transaction giving rise to foreign trading gross receipts of a FSC which is treated as from sources outside the United States shall not exceed the amount which would be treated as foreign source income earned by such person if the pricing rule under Section 994 (DISC intercompany pricing rules) which corresponds to the rule used under Section 925 (FSC transfer pricing rules) with respect to such transaction applied to such transaction.

Comment.—This provision would establish some sort of limitation on foreign source income by reference to the DISC pricing rule of Code Section 994. The meaning is unclear to us, and we do not think that the language is very well composed. Consequently, we will look for an explanation in Treasury's revised technical explanation. Meanwhile, we suggest that the Committee ascertain what is intended, review the propriety of the limitation, and plan to explain the same in the Committee report.

Source Rule (Section 921(d))

This provision states that (1) all foreign trade income of a FSC (other than exempt foreign trade income), (2) all interest, dividends, royalties, and other investment income received by a FSC, and (3) all carrying charges received by a FSC, shall be treated as income effectively connected with the conduct of a trade or business conducted through a permanent establishment of such corporation within the United States. Income described in paragraph (1) would be treated as derived from sources within the United States.

Comment.--We do not know why this source rule would require that nonexempt foreign trade income all be treated as effectively connected with a permanent establishment in the United States. The proposal does not appear to follow the existing source rules set forth in Code Sections 861 through 864. More significantly, as worded, the proposal would seem likely to reduce foreign tax credits for reasons that are not readily apparent to us. We suggest that the Committee ascertain Treasury's rationale for this proposed source rule, and consider in light of that reasoning and the excess foreign tax credit position of many corporate taxpayers whether some portion of the income in question should not be foreign source.

Foreign Office
(Section 922(a)(1)(D)(i))

The term "FSC" would be defined to mean any corporation that, among other requirements, maintains an office located outside the United States during the taxable year.

Comment.--What form must the foreign office take? Can it be part of an existing office if it pays an allocable share of the rent? Can it "share" the personnel of an existing office? We believe that some minimum standards aimed at ease of taxpayer administration should be set forth either in the statute itself or in the Committee report.

Exempt Foreign Trade Income
(Section 923)

Section 923 defines "exempt foreign trade income" to mean the aggregate amount of all foreign trade income of a FSC for the taxable year determined either with or without regard to the administrative pricing rules. In the case of income determined without regard to administrative pricing, 34 percent of the foreign trade income derived from a qualifying transaction would be treated as exempt. For income determined with regard to administrative pricing, 17/23 of the foreign trade income derived from a qualifying transaction would be treated as exempt.

The term "foreign trade income" would mean the gross income of a FSC attributable to foreign trading gross receipts (as defined in proposed Code Section 924).

Comment.--Working backward from the transfer pricing rules of proposed Code Section 925, we do not have any difficulty with the mechanics of computation in ascertaining exempt foreign trade income. However, we feel that the background documents accompanying the bill--particularly the technical explanation--should have explained exactly how the "34 percent" figure and 17/23 fraction were derived. Presumably, the amounts chosen yield results that, in most instances, are equivalent to those under the DISC, consistent with the proposition of the drafters that the proposed FSC should be revenue-neutral. Inasmuch as the computation of exempt foreign trade income is a very sensitive part of the entire proposal and has a direct bearing on the amount of tax benefit to be derived from export transactions, we feel that some illumination (and perhaps liberalization) would be in order.

The Small FSC
(Section 924(b)(2)(B)(i))

A qualifying small FSC would not be subject to the foreign management and foreign economic processes provisions of proposed Section 924(b), (c), and (d). One of the qualification requirements is a limitation on foreign trading gross receipts at $2.5 million. Receipts in excess of that amount would not be taken into account in determining the exempt foreign trade income of such a corporation and would not be taken into account under any other provisions of Subpart C dealing with FSC.

Comment.--To repeat a point made earlier, one wonders why $2.5 million of foreign trading gross receipts was set as the limitation on the exemption of small FSCs from the foreign management and foreign economic processes rules. The revenue cost associated with this rather minor "concession" could no be great, and the Congress should consider raising the amount in question to enhance the usefulness of FSC to small businesses, provided that this can be done without jeopardizing the status of FSC under GATT. The limitation would seem to be particularly confining for smaller companies engaged in low-margin export transactions.

Overseas Receivables Companies
(Section 2(c))

Subsection (a) of Section 553 (defining foreign personal holding company income) would be amended to include income from an account receivable or evidence of indebtedness arising out of the disposition of property described in Section 1221(1), or the performance of services, by a related person (within the meaning of Section 954(d)(3). Subsection (b) of Section 956 (defining United States person) would be amended by adding at the end a new paragraph stating that the term "United States property" includes an account receivable or evidence of indebtedness arising out of the disposition of property described in Section 1221(1), or the performance of services, by a United States person who is a related person (within the meaning of Section 954(d)(3)).

Section 4(a)(2) of the bill would go on to state that the amendments made by Section 2(c) shall apply to accounts receivable and evidences of indebtedness acquired by the foreign corporation after August 4, 1983, in taxable years ending after such date.

Comment.--Our principal concern about these changes is that they are not germane to the FSC legislation. It is our understanding that the Treasury and congressional tax staff wanted these "reforms" (as they refer to them); were not confident that they could accomplish them administratively; and viewed the FSC proposal as a vehicle to help them achieve their purpose. Inasmuch as FSC is enough to have on the agenda at one time, we would prefer to have these items deleted from the bill.

On the merits, overseas receivables companies established as controlled foreign corporations in, typically, low-tax jurisdictions, are viewed by the staff as borderline "subpart F" companies. From the business standpoint, they are effective for (1) managing excess offshore liquidity, (2) reducing affiliates transactional exposures, (3) centralizing credit risk, (4) accelerating cash flow, (5) reducing foreign exchange exposure, and (6) reducing the need for costly short-term external financing. Further, we think that a particularly sound case can be made for these companies in terms of U.S. tax policy where their sole activity is the factoring of foreign affiliates' receivables. In any event, we do not feel that the subect belongs in the FSC bill.

Foreign Tax Credit
(Section 2(d))

It would appear that the FSC proposal would deny the foreign tax credit to the portion of foreign trading income that is taxed by the United States as well as to the tax-exempt portion.

Comment.--Although there is no reason to have foreign tax credits with respect to income that is exempt in the United States, it is not clear to us why the FSC proposal would deny credits for creditable foreign taxes paid with respect to nonexempt foreign trade income. This provision seems objectionable, and should not be retained in the bill in the absence of a clear and convincing policy rationale.

Taxable Year
(Section 3(b))

For purposes of the subtitle in question, the taxable year of any FSC or DISC would be the taxable year of that shareholder (or group of shareholders with the same twelve-month taxable year) having the highest percentage of voting power. In contrast, the technical explanation of June 14, 1983 stated that the taxable year of a FSC would be required to be the same fiscal year as a majority shareholder "(or any other accounting period for which the FSC establishes a business purpose to the satisfaction of the Commissioner.)"

Comment.—Considering that the technical explanation stated that the taxable year of the FSC could be different from that of the parent company for good cause shown, we are uncertain as to why the bill itself does not contain such a provisions. Is this additional flexibility with regard to the taxable year already provided elsewhere in the Code in a provision allowing the Commissioner to approve a different taxable year for a subsidiary? On yet another matter, if a parent company has a September 30 fiscal year, could a FSC still begin on its effective date—presumably the first day of the calendar year—and file a short-year return? If not, why not?

Export Trade Corporation

The FSC technical explanation of June 14, 1983 indicated that the untaxed subpart F income of an export trading company (as defined in Section 505(b)(2) of Public Law 92-178) would be considered treated as amounts previously included in gross income of a shareholder and therefore exempt from taxation.

Comment.—We are unable to find a provision dealing with accumulated income of an export trade corporation in S. 1804. The representation made in the technical explanation should be carried out in the statute.

Service Industries

Some service industries apparently would be covered in the FSC proposal and others would not. Perhaps it would be useful to commission a Treasury study with recommendations to Congress on the matter of extending coverage to other enterprises.

COMMENTS OF CARGILL, INCORPORATED ON THE FOREIGN SALES CORPORATION ACT OF 1983 (S. 1804) SUBMITTED TO THE SENATE COMMITTEE ON FINANCE

Cargill, Incorporated (herein "Cargill") is engaged in the export of such agricultural commodities as grain, oilseeds, cotton, tallow, soybean meal, flour, fertilizer, refined oils derived from oilseeds, corn-based fructose, seeds, boxed beef and peanut-based products. It has used the DISC provisions of the Internal Revenue Code in connection with the export sales of all such products. Cargill strongly supports maintenance of the DISC or the substitution for DISC of FSC benefits that are compatible with the requirements of the General Agreement on Tariffs and Trade (GATT) and which provide benefits essentially equivalent to those now provided by the DISC.

Comments on the Proposed Co-exemption for Cooperatives

Under the present DISC, a producer selling fungible products through an intermediary is not eligible for DISC benefits, whether the producer sells to a producer-owned cooperative or to a proprietary company. Under the provisions of S. 1804, FSC benefits would be extended to such producers, but only if they marketed their production through an eligible cooperative. Cargill opposes the inclusion of this provision in its present form and urges that it be deleted. In this, we support the position taken by Deputy Assistant Secretary of the Treasury, Ronald Pearlman, in his statement to the Committee. If the provision is retained, we urge that benefits be made available to all qualifying producers whether they sell to a producer-owned cooperative or to a proprietary firm. Only in this way can a significant, competitive disadvantage to proprietary firms competing with the cooperatives be avoided.

Comments Covering The Treasury Department's Technical Explanation

Cargill here suggests no other changes in the language of S. 1804, but offers the following comments on the Treasury's Technical Explanation (hereinafter "TE"). In the comments that follow, references to pages and paragraphs are those of the TE.

a. Permanent Establishment Requirement. The first complete paragraph on page 6 states, in part, "More than one FSC may share an office for this purpose, however, the office must constitute a 'permanent establishment' to satisfy this requirement." It is not clear from this whether a FSC which does not share an office must maintain an office which constitutes a "permanent establishment." Cargill urges that the language be clarified to exempt an

FSC which does not share an office from the "permanent establishment" requirement in order to avoid adding an additional foreign activities requirement that would seem unnecessary given the other foreign presence requirements of S. 1804. In any event, to avoid ambiguity, the term "permanent establishment" should be defined.

b. Sale of a Portion of Transaction. On page 12, the third complete paragraph provides an exception for "fungible products" to the general rule that the participation by a FSC in the solicitation, negotiation, or making of a contract must be accomplished on a transaction-by-transaction basis. To avoid a problem of interpretation, Cargill suggests that this exception be expanded to include "fungible products or products sold in bulk."

c. Transportation. The foreign presence requirement pertaining to transportation should be modified to accommodate the special circumstances that exist in marketing of grain and like commodities. Export contracts for the sale of grain, for example, often call for delivery several months after the contract is made. Grain delivered to the buyer's vessel at an export terminal in the Gulf of Mexico is ordinarily drawn from a lot or bin that contains grain, commingled, that originated in several different parts of the country. Thus, in practice it is not possible to identify the origination point of each bushel of grain used to fill an export obligation. To facilitate meeting the foreign presence requirement pertaining to transportation where grain and other commodities ordinarily commingled are concerned, the total direct costs of transportation must be limited to "costs incurred for transportation after the goods have been identified to an export contract." Otherwise exporters of these products will not be able to meet this foreign presence test, and may thereby lose the ability to use the administrative pricing rules.

d. Receipt of Payment. Page 16 of the TE allows the initial payment for an export sale to be "collected by a bank located in the United States as long as such bank has standing instructions to immediately transfer such funds to a bank account of the FSC outside the United States." On letter of credit sales and cash against document sales, the FSC or its agent will be the one, in many instances, that will perform the actual collection task; that is, presenting documents to the buyer, or buyer's bank, for payment. If presentation of documents is made to the buyer's bank, the bank will either issue a check to the collection person, or it will transfer funds directly to an account of the seller via electronic transfers. If presentation of documents is made to a buyer, the buyer will usually notify his bank to transfer funds electronically to a bank account of the seller, or sometimes the buyer will actually present a check to the seller's collection person.

To assure that the receipt of payment test can be met under these circumstances, Cargill suggests that the relevant language be changed to read "initial payment can be received in the United States as long as the proceeds are immediately transferred to a bank located in the U. S. and such bank has standing instructions to transfer such funds immediately to a bank account of the FSC outside the United States."

e. Assumption of Credit Risk. This activity is one of five to be assessed under the "direct cost" test. A FSC would be considered to have performed this activity outside the U. S. if (a) the FSC is contractually bound to assume the credit risk associated with an export sale, and (b) the FSC reduces its foreign trade income by a portion of the actual bad debts incurred from export sales.
Normally, there are no direct costs involved in the assumption of credit risk. Therefore, Cargill urges that assumption of credit risk not be considered one of the activities looked to in determining whether 50% of all direct costs or 85% of the direct costs of two of the activities are incurred outside the United States.

Instead, Cargill proposes that assumption of credit risk should be considered a separate activity. Then, if the 50% test were elected, the assumption of credit risk would be mandatory. On the other hand, if the 85% test were elected, the FSC would be required either to perform 85% of the direct costs of two of the remaining four activities if it chooses not to assume credit risks, or would have to meet one of the four remaining tests if it elected to assume credit risks.

Cargill also urges that assumption of credit risk should be excluded from those activities which must be performed by the FSC if the FSC elects the administrative pricing rules.

Or, Cargill suggests that an activity which might be described as "bad debt collection" be substituted for credit risk activity under the direct cost test. Total direct costs of this activity would include the costs of (1) communicating with delinquent customers, and (2) obtaining legal or collection services required in pursuing delinquent customers. The foreign direct costs would consist of that portion of the total direct costs incurred by the FSC or its agent for the performance of these services outside the United States. The cost of advice from a related supplier to a FSC pertaining to these matters would not be considered.

Conclusion

Cargill supports maintenance of the DISC or the substitution of a FSC which is both GATT-legal and provides support now offered by the DISC. Cargill believes that S. 1804 is workable if the provisions for extending benefits to producers are deleted or appropriately modified and if the Treasury Department's TE is modified as suggested above.

Steven A. Hornig
February 23, 1984

SAH/cv

February 14, 1984

Honorable Robert Dole
Chairman
Senate Finance Committee
Room 219
Senate Dirksen Building
Washington, D. C. 20510

Dear Senator Dole:

Allow us to submit the views on the Foreign Sales Corporation Act of 1983, S. 1804, from several members of the Industrial Sector Advisory Committee for Small and Minority Businesses. As we note below, these are the views of the undersigned only and not of the committee.

The Industrial Sector Advisory Committee for Small and Minority Business, known as ISAC-14, is one of 14 committees of citizens established under section 135(c)(2) of the Trade Act of 1974, P.L. 93-618, to advise the Secretary of Commerce and the United States Trade Representative about the views, interests, opinions, and concerns of private industry concerning foreign trade. Most other ISAC's represent particular industries, such as leather goods or nonferrous metals. ISAC-14 represents all small and minority businesses, in whatever industry. Its thirty members from around the country serve without compensation and, indeed, even without reimbursement for the cost of travel to reach the meeting place.

ISAC-14 has been particularly active in the past two years of its present membership in the area of export promotion: (i) it has set out a description of the problems peculiar to small and minority businesses; (ii) has provided the Secretary of Commerce with a report on the acts and omissions of one of the district offices of the Small Business Administration in encouraging exports by small and minority businessmen; (iii) has provided the Secretary with a program of publicity and promotion to encourage small and minority businessmen to export; and (iv) is working with the Department of Commerce on an experimental program to use the Foreign Commercial Service at a reasonable fee to identify markets for products, lubricating oils and hydraulic fluids, that the Department does not usually monitor. Representatives of ISAC-14 are also active in bringing the views of small and minority businessmen to various offices of the government and to other advisory, policy, and legislative committees. Among such efforts have been those directed to presenting the views of the Committee members to the Administration concerning the Foreign Sales Corporation bill.

We should like to tell you and your committee members what we have been telling them. Indeed, several persons in the Executive Branch have suggested that we bring our views to you. These views follow. Please note, however, that our Committee is not chartered to present its views to Congress. Its duty is limited to advising the Secretary of Commerce and the United States Trade Representative. Accordingly, the views presented below are those of the three persons who sign this statement.

Although all three are members of ISAC-14, Mr. von Allmen is the chairman of the ISAC, and we believe they represent the views of the other members who have expressed an opinion concerning the bill, this letter is not an official document of the Committee, but only the personal views of the signatories. Descriptive information on the signatories is attached.

The two guiding principles for our suggestions are simplicity in application and attractiveness to lenders -- the first, in order that small and minority businessmen actually use foreign sales corporations (FSC's); the second, in order to help solve probably the most severe continuing problem of small and minority businessmen, obtaining financing on reasonable terms.

Simplicity in Application

After some examination, we are forced to conclude that the transfer pricing rules are the opposite of simple (pp. 14-16, 22, and 23 of the bill). The complexity of them can only dissuade small and minority businessmen from using an FSC. The rules are derived from, and very similar to, the transfer pricing rules for the Domestic International Sales Corporations (DISC's). Two anecdotes concerning DISC's will therefore make our point. A small businessman that we know reports that his DISC was established by one of the eight largest accounting firms. Subsequently, when he changed accounting firms for other reasons, he was told by the successor that his DISC had been set up incorrectly and had to be redone. Faced with this disagreement between two large accounting firms, he is at a loss to know which is correct -- if either. Perhaps both are correct in part. The cost to him of originally establishing the DISC and then redoing it is $30,000, plus the continuing uncertainty whether his DISC is proper. Very few small or minority businessmen will be willing to spend that much money to purchase such uncertainty.

The second anecdote is the report from one of the persons in the Executive Branch that the Internal Revenue Service's audits of DISC's provided the largest return per man hour in deficiencies of any of the Service's audit programs. This is the price of the uncertainty the user of the DISC must pay -- intensive audit, its accompanying expenditure of time and fees for attorneys and accountants, and subsequent assessment of deficiency. The same price will be paid for establishing the FSC's, which have such similar transfer pricing rules. We venture to say that for most small and minority businessmen, this will be a price that they cannot afford.

For small and minority businessmen, provide a simple rule. We suggest this: let all profits from export sales by small exporters be placed in the FSC. This eliminates the need for transfer pricing rules. It still leaves the small exporter the task of calculating its costs of exported goods. This alone is no small problem, especially where the exporter produces more than one product and exports only some of any one product that he produces. One need only think of the complexities of presenting the cost-justification defense of the Robinson-Patman Act, 15 U.S.C. 13(a), Automatic Canteen Co. v. FTC, 346 U.S. 61 (1953), to understand the difficulties the small exporter faces only in calculating his profits from exports. He should not in addition be expected to assume the additional burden of the transfer pricing rules.

Once the profit from the export sales is put into FSC, the percentage for exempt income should be applied against this profit. This percentage should be 34%. There are at least three reasons for this. The first is that this is the percentage in the present version that an exporter, under certain circumstances, may possibly attain. Second, small exporters need such an exemption because of the difficulties that exporting presents for them. In addition to all the other difficulties of being small, they must face, often with no additional staff, the extra tasks and risks of exporting and the disporportionately greater amount of paperwork. Third, an exemption of 34% is probably just the amount that the small exporter needs in order to obtain the financing he now cannot get or cannot get on reasonable terms. This is discussed at greater length below.

We understand that several foreign countries have complained about the exemption for small exporters as presently provided for in the bill. While we do not take the foreign relations of the United States lightly, we believe that in this case the obvious answer is the best one. The effect is de minimis. Small exporters sell a tiny percentage of all of our exports. The increase in the share of small exporters that will follow from our suggestions will still be de minimis.

Attractiveness to Lenders

As we have mentioned above, the most severe continuing problem faced by small and minority exporters is obtaining loans on reasonable terms or even obtaining them at all. The big banks are reluctant to make loans that are, from their point of view, small, and the small banks are fearful of lending where the customers are foreign. All banks cite the burden of paperwork and of loan administration as a serious additional problem for them.

The Small Business Administration is a good friend but only a lender of last resort, and is limited only to a guarantee of up to one-half million dollars, inclusive of any other guarantees the business has from the Administration.

The Export-Import Bank is now trying to fulfill the mandate in its recent re-chartering to extend the benefits of its program to small and minority businesses, but so far results have been few. Up to now it has processed no loan less than five million dollars.

A serious problem with the programs of both the SBA and the Export-Import Bank is that they are primarily guarantors of loans by commercial banks. Even with these guarantors, commercial banks have been very reluctant to make loans to small exporters or to make them on reasonable terms. The main reason appears to be the heavy burden of paperwork and cost of loan administration.

At present, therefore, the problem of financing continues unsolved for most of the small and minority exporters. This bill provides the first effective solution. As we understand the bill, the tax-exempt income, the 34% in our suggestion, can be shared with anyone who is a shareholder in the FSC. Thus, in addition to interest on its loan, a lender to small exporters could receive a share of the tax-exempt income. This additional income, which would pay the relatively high costs of paperwork and loan administration, should be a sufficient inducement to bring lenders to service the small and minority exporters that they are not now serving. At the same time, the cost to the exporter would be approximately no more than the interest on the loan. To take an oversimplified example:

If today the exporter made $200 on an export sale, then, assuming 46% tax rates, he would pay Federal income tax of $92, leaving him $108. Under the bill, however, the exporter would pay taxes on only $132, because, assuming the most favorable circumstances, $68 (34%) would be tax exempt. He would thus pay taxes of $61, leaving $139 ($200 minus $61). If he then paid 50%

of the exempt $68, or $34, to the lender, he would have left $105, only slightly less than he would have today. But he would also have the additional benefit of making the sale he presumably would not otherwise have made without the loan, and this should more than make up for the regular interest that he also would pay.

Further, if the lender performed his service as an Export Trading Company under the Export Trading Company Act, 15 U.S.C.4001 et. seq., he could probably receive insurance under programs of the Export-Import Bank both for 90% of his loan and for the exporter's receivables (that would be assigned to him).

Thus all interested parties benefit: the exporter receives financing he cannot now get and makes additional sales and profits, the lender makes a profit at low risk, the locality where the exporter is located receives extra business, employment, and taxes, and the United States gets the additional exports it so badly needs. And these benefits are brought by the free market, spurred by this bill, rather than by bureaucracy.

To prevent any problems with the IRS later, the bill should specify that the exempt income can be shared among the shareholders of the FSC according to the resolution of the board of directors or shareholders' agreement, in any way they want, so long as such sharing meets a legitimate busines purpose. That way there will be no problem in negotiating the financing arrangements with the bank or other lender, who would become shareholders in the FSC along with the small exporter, and get their share of exempt income in the form of dividends.

Observe that the above example is justification for the 34% as the percentage of exempt income for small exporters. One can expect that the lender will ask for about half of it, because it will have heavy costs of paperwork and loan administration: It must create or help create the FSC, it will have to draft or help draft a shareholder's agreement and by-laws, will delegate an employee to sit on the board of directors, and then will have to make sure that the corporate forms of the FSC are maintained and that all requirements of this bill, when law, and of the Internal Revenue Code in general are met. The lender will have to do these things because, as it is better able to do them than the small exporter, it will be more efficient for the lender to do them. But the cost to the lender to do them will not be light. Half of the 34% exempt income will probably be the amount needed to attract the lender's capital. As the above example shows, the remaining half will keep the small exporters approximately where they are today without this bill but now with reasonable financing and increased sales. Thus the 34% for the small exporter is well warranted.

We see this as the main advantage of this bill for the small exporter -- a resource for obtaining financing on reasonable terms. All other parts of the bill affecting the small exporter should be written to align with or enhance this advantage. The calculation of the amount of the exemption should be simplified, by the means suggested above, so the lender will have a clear idea of how much exempt income it will receive. If the chance for exempt income is the main inducement to lenders that are not now making loans or are making them on unreasonable terms, the amount of exempt income to be obtained must be made definite or else there will not be sufficient inducement. Similarly, other points should be adjusted for the lender's benefit. The tax year for small exporters should be elective and not determined by the tax year of the largest shareholder (see pp. 40-41 of bill). If the lender has a strong preference for a particular tax year but will not be the largest shareholder of the FSC, this just presents an unnecessary obstacle to the loan.

Perhaps a more important change is to change the limit for a small exporter from $2,500,000 to $10,000,000. Those companies who sell items of high cost but not of high profit will be unduly squeezed by $2,500,000. Again this should be seen in light of the need to attract financing on reasonable terms. The lower limit will provide the average exporter too little exempt income to interest lenders. Assume the exporter makes 10% on sales. Ten percent of $2,500,000 is $250,000. Thirty-four percent of that is $85,000. One-half of this is $42,500. This cannot be considered a sufficient inducement for lenders who have shown great reluctance until now to make their funds available.

Yet by raising the amount to $10 million, you will still not have so large an effect that foreign members of GATT can reasonably complain.

In sum, we suggest as guiding principles for the provisions concerning small FSC's, simplicity in application and attractiveness to lenders. Follow these principles and you will free from entangling complexity and lack of capital the entrepreneurial spirit of American small and minority exporters.

We add one other point. At present the bill does not allow an exemption for the income of services exported by small and minority businessmen, with two minor exceptions (p. 7 of bill). One argument for not doing so is not persuasive: that the FSC's are supposed to be revenue-neutral regarding the DISC's and there were no greater benefits for services under the DISC's. The answer to this is that our economy had changed considerably in the last twelve years since the DISC law was passed; services now make up a larger share of the gross national product. Many industries that produced goods then are now either gone or much reduced in volume. Unless we allowed services to benefit from FSC's, the FSC bill would not be revenue-neutral; it would reduce the tax benefits that were enjoyed when the DISC law was passed.

A second argument for not doing so is more persuasive. The common rule of international tax law is that the country where the service company performs its services may impose its taxes; the U.S. will give a credit under its taxes for the taxes paid to the host. Whatever additional credit the U.S. may give will just be "soaked up" by the host country by an increase in its tax rate. But even assuming that all or most host countries would apply this "soak-up" tax, the point would not apply to those services rendered to foreigners in ways not taxable by the foreigners' governments. In these cases, the small and minority exporter of services should have the same 34% tax exemption as the small and minority exporter of goods.

Allow us to direct your attention to H.R. 4741, recently introduced by Congressman Henry Nowack. There, small exporters are allowed up to $10 million of exports, services are included, and flexibility in tax year for the small exporter is allowed.

Thank you for allowing us to submit these comments on the proposed bill.

Yours truly,

Erwin von Allmen per RL
Erwin von Allmen

Donna Foster per RL
Donna Foster

Richard Levy
Richard Levy

DESCRIPTIVE INFORMATION ON THE SIGNATORIES

Erwin Von Allmen is president of W. C. Smith, Inc., in Philadelphia, Pennsylvania, manufacturers of confectionary production machinery. W. C. Smith, Inc. has been a serious exporter for over ten years, exporting between one-fourth and one-half of its production. It was awarded an E by President Ford for outstanding export performance.

Among many other activities devoted to increasing exports by small minority businesses, Mr. Von Allmen is the chairman of ISAC 14 and a member of the District Export Council for Philadelphia.

Donna Foster is a member of the board of directors of the Chamber of Commerce of Fairfax County, Virginia, and has been a member for four years of the Chamber's Committee on international trade. She was one of the Chamber's representatives on the trade mission to Zurich in October 1983, to promote exports from Fairfax County.

She has been president of Foster Consultants of McLean, Virginia, for the past ten years, a company that, among other things provides foreign language capabilities, such as translations, and expertise in foreign trade.

Richard Levy has been heavily involved in the experimental program of the Department of Commerce to find foreign markets for lubricating oils and hydraulic fluids sold by small and minority businessmen.

He is an attorney with offices in Alexandria, Virginia.

84-08

SUBMITTED STATEMENT OF AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS ON S. 1804, THE FOREIGN SALES CORPORATION ACT OF 1983

February 17, 1984

The AFL-CIO opposes S. 1804, which would replace domestic international sales corporations (DISCs) with foreign sales corporations (FSCs) providing similar tax giveaways for export-related activities. Continued manipulation of the nation's tax code is unwarranted. We support the termination of DISCs with no new tax gimmicks established as a replacement.

DISCs were established in 1971 in order to offset purported tax-related disadvantages born by U.S. export industries, and were supposed to provide a net increase in the nation's exports. Under current rules, DISC benefits (deferral of tax on 42.5% of profits) apply to income attributable to export receipts in excess of 67 percent of export receipts in a 4-year base period.

Foreign nations, particularly members of the European Community (EC) opposed the DISC provision on the grounds that it violates the General Agreements on Tariffs and Trade (GATT) rules against subsidizing exports with tax breaks.

The proposal to replace DISCs with FSCs is an attempt to conform to GATT rules by establishing certain foreign presence requirements. To qualify as an FSC, an entity must be organized under the laws of a foreign jurisdiction, and must have at least one director who is not a U.S. resident. It must keep an office outside the U.S. and maintain certain bookkeeping operations both at that office and in the United States. Shareholders' meetings, board meetings, and the entity's principal bank account must be held outside the U.S. The FSC provision would establish a tax exclusion, in contrast to the DISC program which allows an indefinite deferral of tax on a portion of qualified export income.

Although the replacement of DISCs with FSCs may address objections raised under the GATT, the fact remains that such tax gimmicks cost billions in revenues but provide no meaningful benefit in terms of improved trade performance or increased employment.

More than a dozen years after the enactment of DISC legislation, the nation has the worst trade balance ever recorded, while the cost of the program in lost federal revenues has continued to climb. The federal budget for fiscal year 1985 estimates that DISCs will cost $940 million in lost federal revenues, compared to $870 million in fiscal year 1984.

Under a flexible exchange rate system, tax-oriented export-incentives are ineffective. Such export incentives are offset by an appreciating dollar, which makes U.S. exports more expensive in foreign markets, and makes foreign imports cheaper in the United States. Improvement in the nation's trade performance is best achieved by enforcing the nation's laws, implementing a fair trade policy, and improving monetary and fiscal policy, not through new tax gimmicks.

DISCs and FSCs also suffer from inadequate targeting -- a deficiency inherent in tax-based incentives. There is no assurance that the benefits provided by the tax gimmick will be reflected in lower export prices. Many other uses for the tax windfall exist, including increased dividends, higher retained earnings, increased executive compensation, or a rise in foreign investment. These uses defeat the programs' ostensible purpose of promoting exports and creating employment here in the United States.

Another problem is that the benefits of such programs tend to be heavily concentrated in the hands of a small number of large firms. In 1981, for example, the Treasury Department reported that 35.2% of the benefits of the DISC program went to only 26 DISCs, out of the 8665 DISCs in existence that year. This is because a handful of firms conduct a large share of total exports.

One justifiction for the establishment of the DISC program in 1971 was that U.S. corporations supposedly were more heavily taxed than their foreign-based competitors. During the period since the program's enactment, however, numerous tax changes have bestowed massive largesse upon U.S. corporations, removing any possible tax disadvantage. The investment tax credit was restored in 1971 and liberalized in 1975, the corporate tax rate was reduced from 48 to 46% in 1979, and the corporate tax was virtually eliminated as a meaningful source of revenues by the accelerated cost recovery provisions of the 1981 tax act.

The federal budget deficit, currently running between $180 and $200 billion, is a principal source of high real interest rates in the United States. The relatively high yields on dollar-denominated assets have caused the foreign exchange value of the dollar to appreciate significantly, raising the price of U.S. exports in overseas markets and making foreign imports cheaper here in the United States. To improve the nation's trade competitiveness requires a reduction in the federal budget deficit.

Tax loopholes benefiting corporations and the rich represent a significant drain on federal revenues, and should be closed in order to cut the deficit, reduce interest rates and improve the nation's trade balance. Terminating DISCs would generate a cumulative addition of $10.9 billion in federal revenues in fiscal years 1985 through 1989. Enacting the FSC proposal would, however, create a new revenue drain.

The AFL-CIO believes there is no need for export promotion through tax preferences. Experience with the DISC program demonstrates that such tax gimmicks cost billions but have no perceptible positive influence on the nation's trade balance. We believe that the DISCs should be terminated, and not replaced by FSCs.

Statement of

Honorable Armistead I. Selden, President

American League for Exports and Security Assistance, Inc.

to the

Committee on Finance

United States Senate

on

S.1804

"The Foreign Sales Corporation Act of 1983"

February 3, 1984

Mr. Chairman, Members of the Committee:

The American League for Exports and Security Assistance (ALESA) appreciates the opportunity to present testimony to the Senate Finance Committee with respect to S.1804, which would provide a substitute for the current Domestic International Sales Corporation (DISC) program. We believe this is a critical piece of legislation which should be passed in this session of the Congress.

I should first note that ALESA is a labor-management organization currently consisting of five national and international unions and thirty three U.S. corporations employing hundreds of thousands of workers. A list of our membership is attached. ALESA's principal goal is to encourage the export of American goods and services in consonance with the security and economic goals of this country.

As the Committee members are well aware, the DISC was originally established not to give American companies an advantage over foreign competitors, nor simply to provide American companies with a little extra profit. The DISC was intended to provide American companies with tax treatment similar to that already normally accorded to foreign competitor companies by their home governments, and to provide an added inducement for American firms to focus more attention on export markets. We believe that in general the DISC accomplished those objectives. However, as we all know, in 1981 the GATT Council determined that the DISC was a subsidy under GATT rules, and should be terminated. The legislation we are reviewing is an attempt to maintain a similar program to the DISC which meets with GATT approval.

It seems to us there are two basic questions the Committee must address in its deliberations on this legislation. First, is such a program still necessary? Second, is there any real reason to change the current program simply to comply with a questionable GATT determination?

For economic reasons, we strongly believe the basic program should be continued. Treasury Department studies generally indicate that the DISC has had a positive effect in increasing exports. Given the current staggering American balance of trade deficit, the difficulty American exporters face in pricing their goods in overvalued dollars, and the slow rate of economic recovery among our trading partners, this is hardly the time to abolish a program which has a positive effect on our export levels. We need increased exports to improve employment levels, assist industry to get back on its feet, and bring our international financial accounts back into balance.

We also believe there are strong political reasons to maintain this program. Our long term trading objective should be to reduce the role governments play in offsetting the real competitive forces which would otherwise determine international trade flows. To do so, we must gradually attempt to obtain agreements on common practices in such areas as tax treatment, tariff and non-tariff barriers, export credits, and other government subsidies. Unilaterally dropping the DISC system without any corresponding change in the tax policy of our competitors will certainly not provide our trading partners any incentive to bring their tax practices more into line with our own in the future.

The issue of conforming to the GATT is more complex. There are certainly strong arguments against the GATT determination that the DISC is a subsidy. However, the United States is the world's largest participant in the international economy. We have a strong vested interest in strengthening multilateral institutions which facilitate international trade and financial flows. To ignore the GATT would be inconsistent with that interest. It is to our long run advantage, therefore, if we can devise a system which provides essentially the same benefits as the DISC while at the same time avoiding an appearance of inconsistency with the GATT.

ALESA members do have some specific concerns with respect to the interpretation of several provisions in the proposed legislation. However, it is our belief that these reservations can be resolved when the Executive Branch devises a set of administrative regulations to put the new program into effect. Overall, we believe it is so important to pass the legislation in this session, that we should not risk becoming sidetracked trying to tie up all loose ends through changes in statutory language.

We do have one major concern, however, which requires a statutory remedy. The current DISC legislation provides that the tax benefits available to a company when it exports military equipment are only half those benefits provided for all other exports. S.1804 as currently drafted continues this discriminatory treatment. We believe that this provision should be dropped.

Through the Arms Export Control Act, the Congress has already assured that no exports of military equipment will be licensed which are contrary to the national interest. The Export Import Bank is prohibited from financing defense related equipment, a practice which is by no means emulated by our overseas competitors. Most sales of defense equipment are made against tough competition to NATO and other allied industrial countries, and to relatively wealthy Third World countries, neither of which receive Foreign Military Sales (FMS) financing.

It is, therefore, unclear why there should still be yet another roadblock in the way of U.S. exports of defense equipment. From the perspective of a machinist, or welder, or design engineer, or longshoreman, it is unclear why the government should encourage the export of an engine going into a civilian aircraft or vehicle, while showing less interest in whether the same or similar engine is exported if it goes into a military aircraft or vehicle. Either way, the question is whether the government prefers to see those American workers employed, as opposed to their European, Asian, or other counterparts overseas. We, therefore, conclude that in the case of the DISC or its successor program, all exports should receive similar treatment.

Mr. Chairman, once again I would like to note ALESA's appreciation for the opportunity to present our views to you and the Committee. We strongly urge that you report out this bill quickly and work for its early passage.

American League for Exports and
Security Assistance, Inc.

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Avco Corporation
Beech Aircraft Corporation
The Boeing Company
Ducommun Incorporated
EDO Corporation
Elexco International, Inc.
Emerson Electric Company
FMC Corporation
Frost and Sullivan, Inc.
Garrett Corporation
Gould Inc.
Harsco Corporation
Hughes Aircraft Company
Hughes Helicopters
Lear Siegler, Inc.
Lockheed Corporation
LTV Aerospace and Defense Company
  AM General Division
  Sierra Research Division
  Vought Aero Products Division
  Vought Missiles and Advanced Programs Division
Martin Marietta Aerospace
The Mead Corporation
Napco Industries, Inc.
Northrop Corporation
Pneumo Corporation
Raytheon Company
Rockwell International
Rohr Industries, Inc.
Sears World Trade, Inc.
The Singer Company
Teledyne, Inc.
United Technologies Corporation
UTL Corporation
Westinghouse Electric Corporation

UNIONS

Communications Workers of America, AFL-CIO
International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers
International Union, United Automobile, Aerospace and Agricultural Implement Workers of America
Marine Engineers Beneficial Association, AFL-CIO
United Brotherhood of Carpenters and Joiners of America, AFL-CIO

THE PILLSBURY COMPANY
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MINNEAPOLIS, MINNESOTA 55402

K. A. JOHNSON
VICE PRESIDENT AND TAX COUNSEL

612/330-4920

STATEMENT OF THE PILLSBURY COMPANY ON S. 1804, THE FOREIGN SALES CORPORATION ACT OF 1983

The Pillsbury Company ("Pillsbury") processes and exports food products and is also actively engaged in the export of raw agricultural commodities such as grain and soybeans.

Pillsbury has utilized the DISC provisions of the Internal Revenue code both in connection with its export of raw agricultural products as well as its export of food products which are processed in the United States. Pillsbury has found that the DISC provisions have been of material assistance in encouraging export transactions and in providing the incentive necessary to make the required investment in export assets. While we are satisfied to continue with DISC as it is now drafted, we appreciate the GATT and other international considerations that are involved and support the efforts of the Administration to develop a GATT-legal alternative to DISC that provides comparable benefits to existing DISC users.

Pillsbury has been most concerned about those provisions of the foreign sales corporation (FSC) proposal which require foreign presence in order for an exporter to qualify. This has been a particular problem in the case of Pillsbury's export of raw agricultural products since agricultural exporting generally takes place in a different context than the export of industrial or other processed goods. For example, agricultural exporters generally do not advertise or engage in extensive sales promotion. Also, agricultural exports are characterized by substantial amounts of transportation within the United States before the commodities reach the point of export loading, and frequently title passes to the purchaser within the boundaries of the United States. Accordingly, U.S. agricultural exporters may not be paying for any foreign transportation. In addition, most agricultural sales do not involve the extension of credit. Finally, many agricultural exporters, large and small, carry on extensive export activities with no foreign presence whatsoever and may deal with foreign and domestic customers whose offices are located within the United States.

Pillsbury had made known to the Administration its concerns with the provisions of S.1804, and has been pleased by the cooperative attitude reflected by the officials of the office of the U.S. Trade Representative and by the Treasury Department. These agencies have been most cooperative in seeking to develop solutions to the problems presented by the FSC legislation to the agricultural exporting community. The technical explanation of S.1804 sent to Chairman Dole on February 1, 1984 by Deputy Assistant Secretary Pearlman is a helpful document in that it spells out in considerable detail the position of the Treasury Department on many of the most ambiguous provisions of the legislation. We believe that it is essential that the language of the technical explanation be incorporated in the Finance Committee's report on S.1804 so that it forms the basis of regulations, if the legislation is ultimately enacted. It would simply not be acceptable for the Internal Revenue Service to have the ability to draft regulations based upon the existing bill without the guidance contained in the technical explanation. This is legislation that requires as much certainty as possible and we believe that the language of the technical explanation should be reflected in the legislative history of the bill.

Pillsbury does, however, have considerable concern over the application of the 50 and 85 percent direct cost tests as they relate to the "assumption of credit" category for purposes of the foreign economic processes that must be met in order to earn foreign trading gross receipts. The Treasury's technical explanation states that the FSC will be considered to bear such credit risk "if it contractually bears such risk," but then goes on to suggest that no costs are incurred unless the debt becomes uncollectible. This is a completely unrealistic and undesirable interpretation since it appears to indicate that even if an exporter has assumed a credit risk (which risk amounts to a contingent liability of the exporter), the direct costs relating to this item cannot be met unless the debt becomes uncollectible. This approach seems to place an undue premium on having poor credit experience, an approach which is at variance with what the legislation should be encouraging. Pillsbury urges that the credit risk test be deemed satisfied if the exporter can demonstrate that it has contractually borne the credit risk involved, regardless of whether there has been a bad debt arising from the transaction.

Pillsbury strongly supports the position expressed by Deputy Assistant Secretary Pearlman at the February 3, 1984 hearing in which he stated that proposed Section 927(a)(4), relating to fungible agricultural products exported through cooperatives be deleted from the legislation. This provision would place private agricultural exporters at a significant competitive disadvantage and could result in a proliferation of pooling arrangements which would greatly distort competition between cooperatives and other exporters. It could also, as reflected in Treasury's statement, result in a significant revenue loss to the Treasury.

CONCLUSION

Pillsbury supports enactment of S.1804 if the Congress believes that it is necessary to replace DISC with a GATT-compatible substitute. However, Pillsbury believes that it is essential the language of the Treasury technical explanation of February 1, 1984 be incorporated in the legislative history of the legislation, and that the assumption of credit risk test of Section 924(e)(5) be deemed satisfied if a FSC has contractually borne a credit risk even if it incurs no bad debts. Pillsbury also supports the proposed deletion of the agricultural cooperatives provision as recommended by Treasury in its testimony.

We would be pleased to work with Congressional staff members in developing any legislative or Committee report language to implement the foregoing objectives.

Kenneth A. Johnson
Vice President and Tax Counsel
2/14/84
Dated

STATEMENT OF THE SYNTHETIC ORGANIC CHEMICAL MANUFACTURERS ASSOCIATION REGARDING THE FOREIGN SALES CORPORATION ACT OF 1983 (S. 1804)

The Small Business Committee of the Synthetic Organic Chemical Manufacturers Association, Inc. (SOCMA) welcomes this opportunity to submit this statement in connection with the Committee's hearings on S. 1804, the Foreign Sales Corporation Act of 1983. SOCMA is a nonprofit association of producers of organic chemicals. A majority of its one hundred members are small companies with annual sales of less than forty million dollars. A list of SOCMA members is attached to this statement.

SOCMA commends the efforts of the Senate Finance Committee to develop legislation which will meet the objections of our GATT trading partners yet maintain the important export incentive that the DISC program has provided for American business. We feel that S. 1804 represents a significant step toward this goal, and, with only a few exceptions, we would urge the speedy enactment of its provisions.

Our primary reservation is that provisions of S. 1804 are not adequate to protect the interests of small businesses. To a large corporation with already substantial foreign contacts, the establishment of a Foreign Service Corporation (FSC) may not be particularly burdensome. However, the foreign presence and management requirements of S. 1804 (Section 924(d)) would prevent the vast majority of small business from availing themselves of the FSC tax benefits and thus discourage them from engaging in export sales. Clearly, this is a consequence that the American economy can ill afford.

S. 1804 has attempted to mitigate this problem by including some provisions which would enable certain small businesses to maintain the tax advantages they currently enjoy under the DISC system by establishing small FSCs (Section 922(b)), jointly owned FSCs, or interest charge DISCs (Section 995). While we endorse the objectives of these provisions, we are concerned that they will not be sufficient to meet the needs of most of SOCMA's small business members. We therefore recommend that S. 1804 be amended to make these and other options available to more small exporters.

Small FSCs

Under Section 924(b)(2), a FSC with $2.5 million or less in foreign trading gross receipts would be exempt from the most costly of the foreign management and economic process requirements and would be permitted to retain only a de minimus foreign presence. Such an FSC would still be required to maintain an office outside the United States, keep a summary of its permanent books at its foreign office, and have at least one director who resides outside the United States. However, its management, bank accounts, and major economic activities could remain in the United States.

We believe that this provision is essential to the continued success of America's small export firms. However, the $2.5 million limit will freeze out the majority of SOCMA's small to medium-sized member firms. These businesses typically generate enough gross receipts to disqualify them from the Small FSC exemption, yet their profits will not be large enough to allow them to meet the onorous requirements for establishing an ordinary FSC.

SOCMA therefore urges that the limit be raised to $5 million. We feel that this is a far more realistic figure, and we believe that it would significantly ease the burden on the American export industry. In addition, we would like to lend our support to the suggestion of the Chamber of Commerce of the United States that transitional limits of from $10 million down to $5 million be used over the next five years to allow firm time to comply with the new tax laws.

Jointly-Owned FSCs

S. 1804 would allow companies to reduce some of the costs of establishing their own FSCs by grouping together and organizing jointly-owned FSCs. We applaud this plan as a useful option for small businesses which would like to enter the export market but cannot afford the initial capital expenditures which setting up an independent FSC would entail. However, we would urge the Committee to insert an explanatory provision into the legislation, or to call for the promulgation of explanatory Treasury regulations, which would ensure that such joint ventures will be able to operate in a manner that will not require the disclosure to all shareholders of a participant's confidential business information such as product sales and profit on such sales.

Interest Charge DISCs

Section 2 of S. 1804 would permit small businesses with less than $10 million in export gross receipts to maintain their current DISCs, but would require them to pay interest at the Treasury bill rate on the tax deferred. SOCMA does not view this as a viable alternative to the DISC program now in effect. The medium sized firms with DISCs which might benefit from such an option are disqualified by the $10 million limit, while the smaller firms which qualify are the least able to afford the extra interest cost. The only benefit this alternative would provide to these small businesses is the difference between the Treasury bill rate interest charge and the present cost of borrowing money, a benefit substantially less attractive than the current DISC rules or the proposed FSC rules.

SOCMA therefore recommends that the qualifying limit for this option be raised from $10 million to $25 million for a five year transition period to enable more firms with existing DISCs to take advantage of it while they form FSCs. In addition, we suggest that S. 1804 be amended to provide an alternative DISC-type mechanism for the smallest exporters. This provision should enable a company with $164,000 or less in taxable export income (the small business definition in § 995(f) of the Internal Revenue Code updated for inflation since January 1, 1976) to maintain a DISC in the United States without paying interest on the deferred taxes if it meets the following minimum requirements:

1. It retains one or more foreign agents who maintain offices outside the United States to represent it in foreign countries;
2. It grants such agent(s) an exclusive or nonexclusive agency agreement, franchise agreement, or distribution license with respect to the product sold; and
3. It engages in foreign economic processes by having its foreign agent(s) perform at least three of the following activities:
   (a) solicit orders from and negotiate sales contracts with customers;
   (b) process customer orders;
   (c) bill customers and receive payment;
   (d) engage in advertising and promotion activities; or
   (e) assume credit risk, risk of loss from casualty, damage, etc. or foreign exchange loss.

A DISC meeting the above criteria would be deemed to be earning income from economic activity outside the United States, as required by the GATT. The amount of income subject to tax exemption would be computed in the same manner as for foreign-based FSCs. We feel that this proposition strikes a reasonable balance between conciliating the members of the GATT Council and ensuring that our smallest exporters are not placed at an unfair competitive disadvantage in the world market.

Conclusion

SOCMA supports the attempt made in S. 1804 to deal with the problems faced by small businesses in establishing and maintaining overseas operations in order to qualify for the FSC tax benefits. However, we feel that the small business provisions, though aimed in the right direction, do not go far enough. We urge the Committee to give serious consideration to the recommendations we have presented so that a greater number of small American businesses may profitably engage in the international export trade.

TESTIMONY BEFORE THE UNITED STATES SENATE
COMMITTEE ON FINANCE
CONGRESS OF THE UNITED STATES

S.1804
FOREIGN SALES CORPORATION ACT OF 1983

by
Ophelia Jatta, President
International Business Development Group, Inc.

Mr. Chairman, I am Ophelia Jatta, President of International Business Development Group and I represent the interest of America's small, women and minority owned businesses. On behalf of these businesses I wish to thank you and the Committee for the opportunity to testify and endorse the passage of the Foreign Sales Corporation Act of 1983.

The passage of the Foreign Sales Corporation Act can create greater harmony between the United States and the European Community. This harmony can lead to increased American trade and investment. We are confident this increased trade by America's larger corporations will make it easier for us - America's small, women and minority owned businesses - to become more involved in exporting and international trade.

The Internal Revenue Code of 1954 created the Domestic International Sales Corporation (DISC). DISC allows the deferral of U.S. income tax on a portion of its export profits. The European Community believes that DISC is a subsidy and not allowed under the Subsidies Code of the General Agreement on Tariffs and Trade (GATT). This controversy has made DISC a highly contentious issue and threatened to slow down progress on other important trade problems. Therefore it is crucial that Congress pass the

Foreign Sales Corporation Act of 1983 to replace DISC with GATT compatible tax rules which do not diminish the competitive posture of American exporters. The Foreign Sales Corporation Act would make it much easier for America to improve its trade deficit and compete for a larger share of the world's market.

The Foreign Sales Corporation Act allows American exporters to have a greater presence abroad by setting up a foreign office and appointing an office director and staff. This added presence abroad will benefit the small exporter and will make it easier for them to enter the export market particularly exporting to developing countries.

Statistics show that small businesses account for 48 percent of the nation's business output, 43 percent of the gross national product, over half of all industrial inventions and innovations, and perhaps most important employ more than 55 percent of the labor force in private industry. Thus small and emerging business enterprises are at the forefront in providing new and better jobs for all Americans.

Companies with twenty or fewer employees provide two-thirds of all new jobs in the private sector ; firms with five-hundred or fewer employees created 87 percent of net new jobs. It is the enterprising young firms four years or less in age that comprise the vigorous new force in job creation. If we are to increase America's strength in the world market we must get this new vigorous force of the small business involved in international trade.

The largest potential sales besides the U.S. market is the world's developing countries where three-fourths of the earth's people live. Other industrialized country governments have recognized this evolving market and enthusiastically aid their home industries in putting together attractive packages in order to consummate sales to developing countries. It has now become a truism that more than ever before America's prosperity depends on trade with developing countries.

With this truism in mind Congress recently passed the Export Trading Company Act of 1982 to encourage the promotion of new export trade. This bill legalized export trading companies. It is now much easier for small and medium sized businesses of all kinds to operate in less developed countries because smaller operators can share the overhead costs involved in overseas operations.

The President and the Congress is also to be commended for passing the Caribbean Basin Initiative. This effort to revitalize the economy of developing countries is necessary because

America's small businesses can achieve their export goals best in an open, market-oriented international system. Therefore we will continue to encourage Congress and the executive branch to work with developing countries who wish to improve their climate for private investment and develop their indigenous private sector in an environment of free and fair markets.

Minority business owners play a special economic role in America. Black Americans alone did more business with corporate

America than China, Russia, Japan & Africa combined. Blacks generated $157 billion plus several times that amount in disposable income last year. In order to effectively flex this economic muscle Blacks are volunteering their time and getting more involved in political decisions and policies affecting their communities.

In keeping with their historical ties Black American entrepreneurs are especially interested in continued Congressional support of the African Development Bank. America has significant political, security and economic interests in Africa which underscore the need to strengthen our ties with the nations of this region.

Recently the Inter-American Development Bank set up a subsidiary equity corporation to sponsor joint venture projects (Inter-American Investment Corporation). We hope the African Development Bank will be encouraged to do the same. These investment corporations can provide capital for export projects and directly benefit America's small businesses.

A recent survey showed less than 1/10 of 1 percent of American people are concerned about major foreign policy issues and decisions. As business owners we feel it is our duty to learn what is best for America and actively participate in foreign policy issues which strengthen our country. With this spirit of caring we want to volunteer our time and our resources to your Committee whenever you require them. Our members are eager to participate in any executive or legislative initiative to help America and its people. When you are planning economic, social, political and trade strategies for investment in EuroAsia, the Middle East and Africa, Japan & China, The Caribbean and Latin America, and other parts of the world, we urge you to remember us and include us in your plans. We are the vigorous force that creates 87 percent of all new jobs in America and we want to do more.

Overall the goal of our testimony today is to let the Committee know we are in full support of the Foreign Sales Corporation Act of 1983 and other legislation which makes it easier for America's businesses to compete in the international marketplace.

Thank you sincerely for the opportunity to address the Committee.

Alcorn, Billings, Camargo, Clinton, Covington, Crescent, Enid, Fairview, Longdale, Navina, Numa, Renfrow, and Wakita.

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MEMBER
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T.E.G.M.A.

STATEMENT

by the

W.B. JOHNSTON GRAIN COMPANY
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to be included in the record of the hearing held

by the

COMMITTEE ON FINANCE
UNITED STATES SENATE

on

Friday, February 3, 1984
SD-219 Dirksen Senate
Office Building

regarding

S. 1804, THE FOREIGN SALES CORPORATION ACT OF 1983

I. Introduction

We are a family owned agri-business company that was founded prior to Statehood in 1893. We are engaged in originating grain from the producer as well as storing and purchasing said grain. Since 1893, the company has been proud of its record of community and customer service. We are indeed proud to be Oklahoma's oldest, and largest, independent grain dealer.

Our DISC was formed in 1980. Since that time, we have used the tax deferrals afforded by DISC to greatly expand our operations and employment. We have also increased the portion of our sales that go for export. In view of our nation's balance of trade deficits and unemployment, we feel we have continued our ideal of community service by using the benefits derived from DISC to provide jobs and increase exports.

Our primary objection to the proposed FSC legislation is the foreign presence requirement. Since we are secondary exporters, we do not currently have offices, employees, or bank accounts outside the United States and hope that we are never forced to do so. Passage of the proposed FSC legislation would require us to establish all three.

II. Summary of Statement

We believe the present DISC program is not in violation of U.S. obligations under the General Agreement on Tariffs and Trade (GATT), and urge that it be retained in its present form.

However, if overriding political considerations make it necessary to repeal DISC, we urge the Committee to consider the points below as it reviews S. 1804, which would substitute the FSC program for DISC.

(a.) Under FSC, two "small business" exceptions are proposed -- an "interest-charge DISC" with $10 million or less in qualified export receipts, and a "small FSC" with receipts of $2.5 million or less. We believe these limitations -- which would allow the sale of only about 58.7 thousand metric tons (2 Ships) and 14.6 thousand metric tons (1/2 Ship) of hard winter wheat, respectively, at current prices -- are too restrictive and should be substantially increased. Many country elevators in the hard winter wheat belt would handle in excess of these amounts during one harvest.

(b.) The requirement that payment must be received outside the U.S. is unworkable and extremely risky. Consider the economic effect on our country's exporters if they had funds on deposit in Argentina in 1981 when its currency was devalued and conversion of funds to U.S. dollars for movement outside of the country was forbidden by law. As a minimum, it should be permissible to deposit payments in a domestic bank account of a FSC.

(c.) We believe many medium-size DISC's with sales too large to qualify for the small business exceptions will be unable to afford the costs involved in actively managing a FSC. We urge that Congress clearly indicate its intent regarding the economic processes which may be carried out for a FSC under contract by another outside the United States.

III. We would propose the following:

(a.) Add a provision in which a secondary exporter sells to a primary exporter and the commodity is going for export, the secondary exporter be allowed to qualify under the FSC without having to meet the foreign presence requirements. (Similar to current DISC requirements.)

(b.) Franchise Company. A U. S. exporter could have a foreign corporation established, for example, in the Virgin Islands, and could assign to that company (on a tax free basis) the worldwide rights for the sale of products or commodities for the parent company. The U. S. exporter would then take back a license to export commodities or other products in payment of a fee to the company holding the exclusive sales rights. The allowable fee would be calculated in relation to current DISC benefits. For example, 1.8% of export sales (used in the FSC pricing) has the flavor of a royalty payment. The qualifying sales would be for export destination, as under present DISC rules. The income of the franchise holding company could be distributed subject to an intercompany dividend received deduction providing the same benefit as in the case of a foreign corporation that is itself selling products under the foreign presence administrative rules provided by S. 1804.

The previous GATT consideration of DISC and related foreign tax practices solely concerned actual selling activities. The GATT rules as they have developed, therefore, focus upon the location of actual selling activities, i.e. solicitation, negotiation, and the making of contracts, processing orders, shipping and the like.

The GATT controversy has not considered taxation of a foreign corporation that would hold trade names, copyrights, or other intangible rights, such as the right to market goods. Such a foreign corporation would be performing the function that it purports to perform. In addition, it is within the discretion of any country to determine whether it will allow a domestic deduction of payments for utilization of such rights to an offshore corporation and the treatment of such income when earned or when distributed. Thus the proposal can be presented as GATT compatible.

The only requirements to be met would be the existence of a foreign corporation and a properly drafted franchise contract. This would provide the type of bright line that would permit simplified, assured compliance and minimal disruption of export activities.

(c.) Foreign Incorporation. The foreign incorporation requirements are likely to be burdensome and costly. An alternative should be provided that would enable a company to form a domestic corporation and elect to have that corporation be treated as foreign corporation for all purposes of the tax law. There is a precedent for such a provision. Present Section 897(i) provides that foreign corporations can elect to be treated as domestic corporations. Such a provision should eliminate the waste of millions of dollars in incorporation fees that would have to be paid to foreign jurisdictions under the present FSC proposal.

(d.) Agricultural Products. The GATT provisions contain a specific reference to incentives for exporting primary agricultural products and specifically allow incentives for exporting these products. The United States should utilize these provisions to authorize a continuation of DISC status for taxpayers involved in the export of primary agricultural products. In such a situation, it would not be necessary for the United States to impose an interest charge.

(e.) Cooperatives. The present proposal to replace DISC with FSC and amend the DISC section of the code contains provisions that would favor agricultural cooperatives at the expense of other agricultural concerns. I recommend that this bias be eliminated so that the law will be neutral as to cooperatives and other agricultural enterprises.

Proposed Section 927(a)(4)(A) should be modified to read as follows: "Fungible agricultural products shall be treated as meeting the requirements of paragraph (1)(B) to the extent that such products are sold for direct use, consumption, or disposition outside the United States." Corresponding changes should be made to the interest payment DISC provisions. Thus, the proposal concerning fungible agricultural commodities would be retained, but the favoritism for cooperatives would be eliminated.

Conclusion

We believe that all of the above proposals are necessary to give the U.S. exporter the flexibility to choose which is best for his particular operation to remain a DISC or a FSC. We also believe that the exporter should be given this opportunity of choice, as we feel it is in the best interest for the United States to keep the capital investments, bank accounts, and employment in the U.S. rather than foreign countries.

It appears that we have our economy turned around and that employment is on the rise, capital spending is beginning to increase, and it's our belief that we should continue to keep them moving in this direction. The above proposals would assist the U.S. exporters in doing their part in boosting the U. S. economy.

There are some U.S. banks that we would not want to use for depositories, let alone foreign banks, particularly after the experience we've had with the demise of the Penn Square Bank in Oklahoma.

As a secondary exporter, we urge you to give us the options that are economically sound for us to compete with the large domestic, international and foreign exporters. We're not asking for any preferential treatment, just an opportunity to be competitive with all U.S. and foreign exporters.

Respectfully submitted,
W. B. JOHNSTON GRAIN COMPANY

Lew Meibergen

Lew Meibergen
Chairman & Chief Executive Officer

JOHNSTON SEED COMPANY

Specialists in
Alfalfa
Small Grains
Love Grasses
Cowpeas
Mung Beans

411 WEST CHESTNUT
BOX 1392 • PHONE 405/233-5800
ENID, OKLAHOMA, U.S.A. 73701

MEMBERS
AMERICAN SEED TRADE ASS'N
WESTERN SEEDSMEN'S ASS'N
SOUTHERN SEEDSMEN'S ASS'N
TEXAS SEEDSMEN'S ASS'N
OKLAHOMA SEEDSMEN'S ASS'N

STATEMENT

by the

JOHNSTON SEED COMPANY
P.O. Box 1392
411 West Chestnut
Enid, Okla. 73702

to be included in the record of the hearing held

by the

COMMITTEE ON FINANCE
UNITED STATES SENATE

on

Friday, February 3, 1984
SD-219 Dirksen Senate
Office Building

regarding

S. 1804, THE FOREIGN SALES CORPORATION ACT OF 1983

I. Introduction

We are a family owned seed company that was incorporated in 1946 after operating as a proprietorship since 1893. We are engaged in origination and contract production from the producer of primarily small grain seeds, native and tame grasses, alfalfas, field peas and mungbeans. To the best of our knowledge, it was our Company that introduced mungbean production in the U.S. The mungbean has allowed wheat producers in our area to double crop with a legume. We are very proud of our record of introducing new crops and new varieties of existing crops to our area.

Our DISC was formed in 1980. Since that time, we have used the tax deferrals afforded by DISC to greatly expand our operations and employment. We have also increased the portion of our sales that go for export. In view of our nation's balance of trade deficits and unemployment, we feel we have continued our ideal of community service by using the benefits derived from DISC to provide jobs and increase exports for our farmer producers.

Our primary objection to the proposed FSC legislation is the foreign presence requirement. Since we are small exporters, today we would qualify under either of the exemptions to the foreign presence requirements. We are a member of a family owned controlled group of corporations that includes two DISC. The inclusion of the two DISC automatically precludes us from qualifying for the small FSC exemption even though our export sales, both direct and indirect, are less than 2 1/2 million dollars.

The 10 million dollar DISC exception and the 2 1/2 million dollar FSC exception limits our export sales growth because we do not have foreign offices, employees or bank accounts. Passage of the proposed FSC legislation would require us to establish all three which are economically unfeasible for an exporter of our size.

II. Summary of Statement

We believe the present DISC program is not in violation of U.S. obligtaions under the General Agreement on Tariffs and Trade (GATT), and urge that it be retained in its present form. However, if overriding political considerations make it necessary to repeal DISC, we urge the Committee to consider the points below as it reviews S. 1804, which would substitute the FSC program for DISC.

The requirement that payment must be received outside the U.S. is unworkable and extremely risky. Consider the economic effect on our country's exporters if they had funds on deposit in Argentina in 1981 when its currency was devalued and conversion of funds to U.S. dollars for movement outside of the country was forbidden by law. We are painfully and economically aware of the consequences of such political actions through our experience in attempting to collect on a draft drawn against a customer in Argentina in 1981. As a minimum, it should be permissible to deposit payments in a domestic bank account of a FSC.

III. We would propose the following:

(a.) Add a provision in which an exporter sells to another exporter and the commodity is going for export, the exporter be allowed to qualify under the FSC without having to meet the foreign presence requirements. (Similar to current DISC requirements.)

(b.) Franchise Company. A U.S. exporter could have a foreign corporation established, for example, in the Virgin Islands, and could assign to that company (on a tax free basis), the worldwide rights for the sale of products or commodities for the parent company. The U. S. exporter would then take back a license to export commodities or other products in payment of a fee to the company holding the exclusive sales rights. The allowable fee would be calculated in relation to current DISC benefits. For example, 1.8% of export sales (used in the FSC pricing) has the flavor of a royalty payment. The qualifying sales would be for export destination, as under present DISC rules. The income of the franchise holding company could be distributed subject to an intercompany dividend received deduction providing the same benefit as in the case of a foreign corporation that is itself selling products under the foreign presence administrative rules provided by S. 1804.

The previous GATT consideration of DISC and related foreign tax practices solely concerned actual selling activities. The GATT rules as they have developed, therefore, focus upon the location of actual selling activities, i.e. solicitation, negotiation, and the making of contracts, processing orders, shipping and the like.

The GATT controversy has not considered taxation of a foreign corporation that would hold trade names, copyrights, or other intangible rights, such as the right to market goods. Such a foreign corporation would be performing the function that it purports to perform. In addition, it is within the discretion of any country to determine whether it will allow a domestic deduction of payments for utilization of such rights to an offshore corporation and the treatment of such income when earned or when distributed. Thus the proposal can be presented as GATT compatible.

The only requirements to be met would be the existence of a foreign corporation and a properly drafted franchise contract. This would provide the type of bright line that would permit simplified, assured compliance and minimal disruption of export activities.

(c.) Foreign Incorporation. The foreign incorporation requirements are likely to be burdensome and costly. An alternative should be provided that would enable a company to form a domestic corporation and elect to have that corporation be treated as foreign corporation for all purposes of the tax law. There is a precedent for such a provision. Present Section 897(i) provides that foreign corporations can elect to be treated as domestic corporations. Such a provision should eliminate the waste of millions of dollars in incorporation fees that would have to be paid to foreign jurisdictions under the present FSC proposal.

(d.) Agricultural Products. The GATT provisions contain a specific reference to incentives for exporting primary agricultural products and specifically allow incentives for exporting these products. The United States should utilize these provisions to authorize a continuation of DISC status for taxpayers involved in the export of primary agricultural products. In such a situation, it would not be necessary for the united States to impose an interest charge.

(e.) Cooperatives. The present proposal to replace DISC with FSC and amend the DISC section of the code contains provisions that would favor agricultural cooperatives at the expense of other agricultural concerns. I recommend that this bias be eliminated so that the law will be neutral as to cooperatives and other agricultural enterprises.

Proposed Section 927(a)(4)(A) should be modified to read as follows: "Fungible agricultural products shall be treated as meeting the requirements of paragraph (1)(B) to the extent that such products are sold for direct use, consumption, or disposition outside the United States." Corresponding changes should be made to the interest payment DISC provisions. Thus, the proposal concerning fungible agricultural commodities would be retained, but the favoritism for cooperatives would be eliminated.

CONCLUSION

We believe that all of the above proposals are necessary to give the U.S. exporter the flexibility to choose which is best for his particular operation to remain a DISC or a FSC. We also believe that the exporter should be given this opportunity of choice, as we feel it is in the best interest for the United States to keep the capital investments, bank accounts, and employment in the U. S. rather than foreign countries.

It appears that we have our economy turned around and that employment is on the rise, capital spending is beginning to increase, and it's our belief that we should continue to keep them moving in this direction. The above proposals would assist the

U. S. exporters in doing their part in boosting the U. S. economy and reducing our balance of trade deficit.

There are some U.S. banks that we would not want to use for depositories, let alone foreign banks, particularly after the experience we've had with the demise of the Penn Square Bank in Oklahoma and the problem we are having in Argentina.

As an exporter, we urge you to give us the options that are economically sound for us to compete with the large domestic, international and foreign exporters. We're not asking for any preferential treatment, just an opportunity to be competitive with all U.S. and foreign exporters on an equal basis.

Respectfully submitted,
JOHNSTON SEED COMPANY

Leroy Mack
President

Agri-Products Exporters Association

President
LEW MEIBERGEN
W.B. Johnston Grain Co.

Secretary-Treasurer
ROBERT E. FRANE
Consolidated Grain
and Barge Co.

Vice President
S. REAGAN STONE
Willmar Gin Co.

General Counsel
ROBERT FEINSCHREIBER
Attorney

P.O. Box 15056

Saint Louis Missouri 63110

STATEMENT

by the

AGRI-PRODUCTS EXPORTERS ASSOCIATION
P.O. Box 15056
Saint Louis, Missouri 63110

to be included in the record of the hearing held

By the

COMMITTEE ON FINANCE
UNITED STATES SENATE

on

Friday, February 3, 1984
SD-219 Dirksen Senate
Office Building

regarding

S. 1804, THE FOREIGN SALES CORPORATION ACT OF 1983

I. Introduction

The Agri-Products Exporters Association is a small organization whose membership is composed of mainly agri-businesses of various types throughout the Midwest, upper Midwest and Southwest portions of the U.S. The majority of our members are in the grain and grain related products and bi-products business, all of which are primarily secondary exporters. We do have some members that are not entirely in agri-business such as various financial institutions.

Our primary objection to the proposed FSC legislation is the foreign presence requirement. The majority of us are not large exporters or primary exporters and do not have offices of any type overseas or overseas bank accounts. We sincerely hope that we are never forced to have to open up foreign offices or foreign bank accounts; however in our opinion, the passage of the proposed foreign sales corporation would require us to establish overseas offices, foreign bank accounts, and force us to invest capital outside of the continental U.S.A.

II. Summary of Statement

We urge the Committee to consider the points below as it reviews S. 1804, which would substitute the FSC program for DISC.

(a) Under FSC, two "small business" exceptions are proposed -- an "interest-charge DISC" with $10 million or less in qualified export receipts, and a "small FSC" with receipts of $2.5 million or less. We believe these limitations -- which would allow the sale of only about 58.7 thousand metric tons (2 ships) and 14.6 thousand metric tons (1/2 ship) of hard winter wheat, respectively, at current prices -- are far too restrictive and should be substantially increased. Many country elevators in the hard winter wheat belt would handle in excess of these amounts during a single harvest.

(b) The requirement that payment must be received outside the U.S. is unworkable and extremely risky. Consider the economic effect on our country's exporters if they had funds on deposit in Argentina in 1981 when its currency was devalued and conversion of funds to U.S. dollars for movement outside of the country was forbidden by law. As a minimum, it should be permissible to deposit payments in a domestic bank account of a FSC.

(c) We believe many medium-size DISCs with sales too large to qualify for the small business exceptions will be unable to afford the costs involved in actively managing a FSC. We urge that Congress clearly spell out its intent regarding the economic processes which may be carried out for a FSC under contract by another outside the United States.

III. We would further propose the following:

(a) Add a provision in which a secondary exporter sells to a primary exporter and the commidity is going for export, the secondary exporter be allowed to qualify under the FSC without having to meet the foreign presence requirements. (Similar to current DISC requirement.)

(b) Franchise Company. A U.S. exporter could have a foreign corporation established, for example, in the Virgin Islands, and could assign to that company (on a tax free basis) the worldwide rights for the sale of products or commodities for the parent company. The U.S. exporter would then take back a license to export commodities or other products in payment of a fee to the company holding the exclusive sales rights. The allowable fee would be calculated in relation to current DISC benefits. For example, 1.8% of export sales (used in the FSC pricing) has the flavor of a royalty payment. The qualifying sales would be for export destination, as under present DISC rules. The income of the franchise holding company could be distributed subject to an intercompany dividend received deduction providing the same benefit as in the case of a foreign corporation that is itself selling products under the foreign presence administrative rules provided by S. 1804.

The previous GATT consideration of DISC and related foreign tax practices solely concerned actual selling activities. The GATT rules as they have developed, therefore, focus upon the location of actual selling activities, i.e. solicitation, negotiation, and the making of contracts, processing orders, shipping and the like.

The GATT controversy has not considered taxation of a foreign corporation that would hold trade names, copyrights, or other intangible rights, such as the right to market goods. Such a foreign corporation would be performing the function that it purports to perform. In addition, it is within the discretion of any country to determine whether it will allow a domestic deduction of payments for utilization of such rights to an offshore corporation and the treatment of such income when earned or when distributed. Thus the proposal can be presented as GATT compatible.

The only requirements to be met would be the existence of a foreign corporation and a properly drafted franchise contract. This would provide the type of bright line that would permit simplified, assured compliance and minimal disruption of export activities.

(c) Foreign Incorporation. The foreign incorporation requirements are likely to be burdensome and costly. An alternative should be provided that would enable a company to form a domestic corporation and elect to have that corporation be treated as foreign corporation for all purposes of the tax law. There is a precedent for such a provision. Present Section 897(i) provides that foreign corporations can elect to be treated as domestic corporations. Such a provision should eliminate the waste of millions of dollars in incorporation fees that would have to be paid to foreign jurisdictions under the present FSC proposal.

(d) Agricultural Products. The GATT provisions contain a specific reference to incentives for exporting primary agricultural products and specifically allow incentives for exporting these products. The United States should utilize these provisions to authorize a continuation of DISC status for taxpayers involved in the export of primary agricultural products. In such a situation, it would be necessary for the United States to impose an interest charge.

(e) Cooperatives. The present proposal to replace DISC with FSC and amend the DISC section of the code contains provisions that would favor agricultural cooperatives at the expense of other agricultural concerns. We strongly recommend that this bias be eliminated so that the law will be neutral as to cooperatives and other agricultural enterprises.

Proposed Section 927(a)(4)(A) should be modified to read as follows: "Fungible agricultural products shall be treated as meeting the requirements of paragraph (1)(B) to the extent that such products are sold for direct use, consumption, or disposition outside the United States." Corresponding changes should be made to the interest payment DISC provisions. Thus, the proposal concerning fungible agricultural commodities would be retained, but the favoritism for cooperatives would be eliminated.

Conclusion

We believe that all of the above proposals are necessary to give the U.S. exporter the flexibility to choose which is best for his particular operation to remain a DISC or a FSC. We also believe that the exporter should be given this opportunity of choice, as we feel it is in the best interest for the United

States to keep the capital investments, bank accounts, and employment in the U.S. rather than foreign countries.

It appears that we have our economy turned around and that employment is on the rise, capital spending is beginning to increase, and its our belief that we should continue to keep them moving in this direction. The above proposals would assist the U.S. exporters in doing their part in boosting the U.S. economy.

As primarily secondary exporters, we urge you to give us the options that are economically sound for us to compete with the large domestic, international and foreign exporters. We're not asking for any preferential treatment, just an opportunity to be competitive with all U.S. and foreign exorters.

Respectfully submitted,

AGRI-PRODUCTS EXPORTERS
ASSOCIATION

NATIONAL CONSTRUCTORS ASSOCIATION
BUILDERS AND ENGINEERS FOR INDUSTRY

NATIONAL CONSTRUCTORS ASSOCIATION
1101 15th Street, N.W. Washington, D.C. 20005 (202) 466-8880

February 16, 1984

Mr. Roderick A. DeArment
Chief Counsel
Committee on Finance
Room SD-219
Dirksen Senate Office Building
Washington, D.C 20510

Dear Sir:

S. 1804 (Foreign Sales Corporation Act)

The National Constructors Association ("NCA") has represented many of America's large national construction companies for over thirty years. The organization presently consists of approximately fifty member companies who are engaged in building major process plants and related facilities for electrical power generation; oil refining, chemicals and petrochemicals; paper, mining, steels and metals production and fabrication; and other major process and manufacturing needs. Our industry accounts for more American taxpayers working abroad than any other single industry. Our comments concerning the proposed legislation are as follows:

Foreign Contact Requirements.

To conform to the General Agreement on Trade and Tariffs ("GATT") rules, the Foreign Sales Corporation Act of 1983 (the "Act") provides that a Foreign Sales Corporation ("FSC") must have a foreign presence, it must have economic substance, and activities that give rise to the export income must be performed by the FSC outside the U.S. customs territory. These results are achieved through three sets of foreign contact requirements.

First, to qualify as a FSC, a foreign corporation must have a foreign presence. Foreign presence is achieved by meeting certain definitional criteria and electing to be subject to taxation as a FSC. The definitional requirements for a FSC are as follows:

a. It must be a corporation created or organized under the laws of a foreign country or a U.S. possession;

DESIGNERS & ERECTORS
OIL REFINERIES—CHEMICAL PLANTS—STEEL MILLS—POWER PLANTS

b. A FSC may not have more than 25 shareholders at any time during the taxable year;

c. A FSC may not have any preferred stock outstanding at any time during the taxable year;

d. A FSC must maintain an office located outside the United States and maintain a set of its permanent books of account at that office. It must also maintain sufficient tax records at a U.S. location; and

e. At least one member of the Board of Directors of the FSC must be an individual not resident in the United States, although he may be a citizen of the United States.

The second set of foreign contact requirements is embodied in the definition of foreign trading gross receipts. For a FSC to have foreign trading gross receipts two additional requirements must be met - the foreign management and foreign economic process requirements. A FSC would be treated as having foreign trading gross receipts only if the management of the corporation during the taxable year takes place outside the United States and only if the economic processes with respect to particular transactions take place outside the United States. The management test applies to functions of the FSC for the taxable year. In contrast, the economic process test generally applies to every transaction on a transaction-by-transaction basis.

The requirement that the FSC be managed outside the United States would be treated as satisfied for a particular taxable year if (1) all meetings of the Board of Directors and all meetings of the shareholders are outside the United States, (2) the principal bank account of the corporation is maintained outside the United States at all times during the taxable year and, (3) all dividends, legal, and accounting fees, and salaries of officers and members of the Board of Directors paid during the taxable year are disbursed out of bank accounts of the corporation outside the United States.

Economic processes are treated as taking place outside the United States if two requirements are met. The first requirement is that, with respect to any transaction, the FSC must participate outside the United States in the solicitation (other than advertising), the negotiation or the making of the contract relating to the transaction. This test can be met if either the FSC or any person acting under contract with the FSC has performed one or more of these activities outside the United States.

The second requirement is that the foreign direct costs incurred by the FSC attributable to the transaction must equal or exceed 50-percent of the total direct costs incurred by the FSC with respect to the transaction or that the FSC meet an alternative 85-percent test. The term "total direct cost" (the denominator of the fraction) means, with respect to any transaction, the total direct costs incurred by the FSC attributable to the activities relating to the disposition of the export property. These activities are those performed at any location within or without the United States by the FSC or any person acting under contract with the FSC. The term "foreign direct cost" (the numerator of the fraction) means the portion of the total direct costs incurred by the FSC which are attributable to activities performed outside the United States. Although the activities must be performed outside the United States, either the FSC or any person acting under contract with the FSC may perform the activities.

For purposes of the foreign direct cost test, the costs of five activities relating to the disposition of export property are considered. The activities are (1) advertising or sales promotion, (2) the processing of customer orders and the arranging for delivery (outside the United States) of the export property, (3) transportation from the time of acquisition by the FSC to the delivery to the customer, (4) the determination and transmittal of the final invoice or statement of account and the receipt of payment, and (5) the assumption of credit risk.

The requirement that the foreign direct costs incurred by the FSC equal or exceed 50-percent of the total direct costs incurred by the FSC attributable to a transaction may be met by an alternative 85-percent test. Under this alternative test, a corporation would be treated as satisfying the requirement that economic processes take place outside the United States if the foreign direct costs incurred by the FSC attributable to any two of the five activities relating to the disposition of export property equal or exceed 85-percent of the total direct costs of at least two of these five activities.

The burden of proof with respect to the foreign management and economic process requirements would be shifted to the Secretary of the Treasury if a written statement addressing the issue has been filed by an officer of the corporation. The statement to be filed with the Secretary must be made by an officer of the FSC who is a citizen and resident of the United States, and must be made under penalty of perjury. Furthermore, the statement must declare that the corporation meets the economic process requirements and the foreign management requirements and must specify how the requirements have been met for the particular transactions.

The third set of foreign contact requirements are incorporated into the transfer pricing rules. The taxable income of a FSC from the sale by the FSC of export property in connection with the transaction involving a related supplier may be determined using Section 482 pricing rules, or, if certain conditions are satisfied, one of two administrative transfer pricing rules. In order to use the special administrative pricing rules, a FSC must meet two requirements. The first requirement is that all of the activities with respect to which the direct costs are taken into account for the 50-percent foreign direct cost test must be performed by the FSC or by another person acting under contract with the FSC.

These five activities are advertising and sales promotion, processing of customer orders and arranging for delivery of the property, transportation, billing and receipt of payment, and the assumption of credit risk. The second requirement for use of the administrative pricing rules is that all of the activities relating to the solicitation (other than advertising), negotiation and making of the contract for the sale must be performed by the FSC (or by another person acting under contract with the FSC). These two requirements can be met wherever the activities are performed. The activities do not have to be performed outside the United States.

To summarize, to be treated as having foreign gross receipts and hence foreign trade income, the foreign costs of certain activities relating to the disposition of export property must be substantial (either 50-percent of the cost of all five activities or 85-percent of the cost of two of the activities). To use the administrative pricing rules, all five of the activities must be performed by the FSC or by another person acting under contract with the FSC. Furthermore, other activities (solicitation, negotiation, and making of the contract of sales) must be performed by the FSC or by another person acting under contract with the FSC.

NCA Concerns.

Our main concern with the above provisions is their relevance and applicability to the construction industry. Based on the Administration's explanation of the Act, we would expect that compliance with the definitional requirements of a FSC as well as the foreign management requirements could be met by our members without undue hardship; however the applicability of the "economic process" rules to qualifying construction project services needs substantially more clarification and amplification.

It is obvious that the "foreign economic process" requirements were tailored to apply to corporations engaged in the manufacturing and/or sale of goods abroad and not companies such as ours which export services. Advertising, arranging for transportation/delivery and assumption of credit risks are activities which are a material part of the export process for production companies which are not generally engaged in by construction companies. We believe that the FSC legislation should either be amended to include a separate set of such "economic process" rules for our industry or, at the very least, the legislative history should be drafted to include some specific guidance (by way of example) as to how the tests are to be applied to the facts of our industry.

A second concern is technical compliance with the numerous administrative requirements. Although the Administration's explanation discussed many of the definitional and foreign management requirements, many issues are left unaddressed. Some areas of concern are the establishment and staffing of the FSC's foreign office; if an agent which is a related company must be compensated on an "arm's-length" basis; the exact degree of control a FSC must exert over its business; and if compliance with foreign management and economic process requirements can be demonstrated other than by an officer's verified statement. Although compliance with the many foreign contact requirements may be administratively possible and economically feasible, more specific guidelines are needed to prevent members of our industry from inadvertently failing to qualify as a FSC and to ensure that reasonable and workable regulations that carry out Congressional intent are ultimately implemented.

We appreciate your consideration of our proposals.

Sincerely,

Lawrence N. Fisher

Lawrence N. Fisher
Chairman, Tax Committee

LNF:bjm

National Association of Manufacturers

ALEXANDER B. TROWBRIDGE
President

January 25, 1984

The Honorable Robert J. Dole
Chairman
Committee on Finance
United States Senate
221 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Dole:

I am writing to ask that the Finance Committee act quickly and favorably on S. 1804. This bill is the Administration's proposal to replace the current Domestic International Sales Corporation (DISC) provisions of our tax laws with a new export incentive which uses a Foreign Sales Corporation (FSC). This change is needed to meet long-standing objections by our trading partners that the DISC violates the General Agreement on Tariffs and Trade (GATT).

As you know, NAM testified in support of the FSC concept at the Finance Committee's earlier hearings on S. 1804, held November 18, 1983. At that time, we recommended a number of changes which would both simplify and improve the FSC approach. We remain hopeful that such changes can be accomodated. We believe, however, that the most important goal is to move the Administration's FSC proposal promptly through the legislative process.

Recent statistics on our merchandise trade deficit for 1983 as well as the current account deficit indicate the need for every possible aid to U.S. exporters if we are to retain an adequate degree of competitiveness. Uncertainty about continuation of DISC or availability of an adequate substitute has hindered exporters long enough, and the need for an early solution to this problem is great. NAM therefore urges the Finance Committee to assign a high priority to this legislation.

I request that this letter be included in the public record of the hearings on S. 1804.

Sincerely,

AB Trowbridge

cc: The Honorable Donald T. Regan
The Honorable William E. Brock

1776 F Street, N.W.
Washington, D.C. 20006
(202) 626-3800

Aerospace Industries Association of America, Inc.

Office of the President

January 30, 1984

The Honorable Robert Dole
Chairman
Committee on Finance
United States Senate
221 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

As the national trade association representing the major American manufacturers of commercial, military and business aircraft, helicopters, aircraft engines, spacecraft and related components and equipment, the Aerospace Industries Association of America, Inc. (AIA) has a keen awareness of the critical problems facing the United States in today's international marketplace.

From the aerospace industry's vantage point as a major exporter of high technology products, we are well aware of the importance of exports to both the industry and the national economy, and the benefits derived from a healthy balance of trade. In 1983, the industry's total export volume reached $16.3 billion, contributing to a positive aerospace balance of trade of $12.8 billion.

But the continuing ability of the U. S. aerospace industry to contribute a large trade surplus to the total U. S. balance of trade will depend upon the industry's ability to effectively counter the growing competitive strength of foreign aerospace producers. It is therefore imperative for the United States to strengthen the network of policies and practices that are critical for assisting aerospace -- and other U. S. exporting industries -- to maintain their place in the world market.

Recognizing the importance of exports to their economic well-being, our foreign trading partners have traditionally employed an array of export incentives to their businesses and industries, with direct and indirect tax incentives playing a significant role. In contrast, the United States has had basically only one export tax incentive -- the Domestic International Sales Corporation (DISC). The Administration's proposal to replace DISC

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with a foreign sales corporation (FSC) -- as set out in S. 1804 -- is responsive to complaints raised by other signatories to the General Agreement on Tariffs and Trade (GATT). Furthermore, evaluation of this alternative to DISC by the Treasury Department and the Joint Committee on Taxation indicates that FSC will entail a smaller revenue loss than is the case with current tax provisions.

The aerospace industry firmly believes in the need to replace DISC with an export incentive that is in accordance with U. S. international commitments under the GATT, and strongly supports the Administration's efforts to resolve the controversy with our GATT partners in a flexible framework that aids U. S. exports, refining the required details at the appropriate time. To this end, we strongly urge the Committee to favorably report S. 1804 at the earliest possible date in order to assure final action before the adjournment of the 98th Congress.

Yours very truly,

Karl G. Harr, Jr.

cc: Members of the Committee on Finance

International Economic Policy Association
1625 EYE STREET, NORTHWEST, WASHINGTON, D. C. 20006
331-1974

January 31, 1984

The Honorable Robert Dole
Chairman, Senate Finance Committee
United States Senate
Dirksen Office Building
Washington, D. C. 20510

Dear Senator Dole:

I am writing this letter in support of the principles expressed in S.1804 on the tax treatment of foreign sales corporations under the assumption that our present DISC legislation must be changed. In that event, several areas of the proposed legislation should be clarified as indicated below and I hope that these comments can be included in your hearings record on February 3, 1984.

The International Economic Policy Association is a nonprofit organization, established in 1957 to analyze international economic public policy issues including trade, investments, and taxation that affect U.S. business and our national interest. As you know from our many appearances before your Committee, we have continually supported efforts to strengthen the ability of U.S. business to compete in the world export market. For your information, I am enclosing a list of our Board of Directors.

For over two decades, a separate interpretation to which the United States agreed in 1960 of Article XVI of GATT has caused U.S. exporters considerable problems. We agreed that a rebate of direct income taxes was an illegal subsidy but allowed the Europeans to rebate their indirect value-added taxes (which were being developed at the time). The United States Congress affirmed that executive interpretation for the first time when it passed the Trade Agreements Act of 1979 containing approval of the subsidies code. After repeated promises by past administrations that the question of Article XVI would be renegotiated in Geneva failed, the U.S. Government settled on the DISC to forestall taxes on export income as a counterpart of the rebates of value-added taxes which Europeans were allowed.

Now, however, because of complaints by our trading partners and a finding by GATT, we must rewrite our tax code so that the tax laws on export income will be considered "GATT legal" (even though GATT is an executive agreement and not a treaty approved by the Congress). As indicated above, our first preference would be to leave DISC as in present law but assuming the U.S. must make changes, S.1804 needs modification.

In order for the foreign sales corporation (FSC) tax treatment to have the same beneficial effect as the present DISC, Section 2(c)(1) should be narrowed or deleted from the proposed legislation.

As presently written, this section is aimed at foreign factoring of a domestic receivable. It treats any income earned by a controlled foreign corporation from factoring receivables of an affiliate as foreign personal holding company income for the first time. This is too broad for it not only covers foreign factoring of a domestic U.S. corporation's receivable but the factoring income of a foreign corporation from purely overseas transactions. The net effect of this would be to subject a new category of foreign-source income, earned by a foreign-located company in the active conduct of foreign business, to current taxation in the United States.

The United States tax code has steadfastly held to the basic principle that foreign-source income is not subject to tax until it is actually repatriated, except of course for those provisions of Subpart F which cover abuses. The taxing of income from factoring receivables (generated as a direct result of an active trade or business undertaken outside the United States) would jeopardize the present export trade financing undertaken by many U.S. corporations. Since under the present DISC, such income is not taxable in the U.S., deletion of this provision would not place a presently taxable source of income into nontaxable status and would therefore mean no loss of revenue to the U.S. Treasury.

Second, many U.S. exporters have used the commission, rather than the resale type of DISC; and the changes made by the legislation in Section 924(e) could cause a hardship for commission-type foreign sales corporations. We believe that the qualifying activities in this type of FSC must be modified to accommodate those activities undertaken by a commission-type foreign sales corporation while allowing the parent to undertake its normal and customary duties.

Third, we believe that the foreign presence test requiring that 50 percent of the direct costs associated with specified items (or 85 percent of two of the five specified items) be performed outside the United States is too rigid. Under the present DISC rules, we understand that there can be a taxable distribution to permit qualification of the income. The foreign sales corporation should have a specific allowance for partial qualification if after all good faith efforts are made, the statistical qualification for all income to be nontaxable is not met.

Fourth, the legislation mandates a "short year" for present DISCs by requiring that they terminate by December 31, 1983 and treats any past accumulated income as previously taxed. However, some DISCs might normally end their business year on a date after December 31st. The December 1982 Treasury Department report on DISCs, for instance, shows that 46.2 percent of the tax returns analyzed were for accounting periods ending between January and June (with 29.3 percent between February and June). This is a significant number and in shortening their tax year to less than twelve months, their DISC status could be jeopardized by not being able to meet the qualification rules. We believe that present DISCs should be allowed to use a modified asset qualification rule exempting them from the asset test in the shortened year. Alternatively, the DISC should be allowed to finish out its natural year so that it can meet the qualification rules in its normal course of business.

Fifth, we believe that Section 2(a) amending "Section 922. FSC Defined, (a)(1)(B)" should not limit an FSC to "no more than 25 shareholders." Congress has made a conscious effort in its policies to encourage small, medium and large companies to export in the recently passed Export Trading Company legislation. In an effort to have groups of companies export, an FSC open to participation by all agreed producers of a product or service should be encouraged. The U.S. policy should be to maximize our export base and therefore FSCs should not be limited at 25 members.

Sixth, the Congress should raise the limitation of foreign trading gross receipts for small FSCs from the low base of $2.5 million to $5 million. We estimate that based on Treasury Department data this would represent less than 5 percent of the total gross receipts of all 1980 DISCs, about 7 percent of their total net income, and about 8 percent of the total so-called tax-deferred income. It would be a small price to pay for encouraging a greater number of non-*Fortune* 500 companies to export and lower U.S. unemployment.

Finally, we applaud you and the Administration for proposing that past accumulated DISC income is to be deemed previously taxed as of December 31, 1983; for if this legislation were to move through the Congress without this provision for grandfathering past DISC benefits, we would have to oppose passage of any part of it.

The United States faces a potential trade deficit of over $100 billion in 1984 and close to an $80 billion current account deficit for the same year. The drain from this on our domestic employment is now of crisis proportions. We must take every step possible to aid our exporters in a world fraught with sharp competition that is not always free and open, and often based on special incentives, rebates and credits by foreign governments. To sit back and do nothing is a sure prescription for deindustrialization; we must be prepared to equip our exporters with the same advantages given to others.

Thank you for allowing us to present our views on this legislation.

Sincerely,

Ronald L. Danielian

Ronald L. Danielian
Executive Vice President
and Treasurer

Enclosure

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JUNE 1983

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January 3, 1984

By Hand

Roderick A. De Arment
Chief Counsel
Committee on Finance
U. S. Senate
221 Senate Dirksen Office Building
Washington, D. C. 20515

Dear Rod:

Enclosed for your convenience is a copy of my December 9 statement for the record of the November 18 hearing on the pending FSC legislation (S. 1804).

I assume that it is not necessary to file again this statement for the record of the recently announced February 3 hearing. If, however, I am wrong in this regard, please make my December 9 statement a part of the February 3 hearing record.

Sincerely,

Jerry

Jerry L. Oppenheimer

JLO/sr
Enclosure

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December 9, 1983

By Hand

The Honorable Robert J. Dole
Chairman
Committee on Finance
U. S. Senate
221 Senate Dirksen Office Building
Washington, D. C. 20510

Re: November 18, 1983, Hearing on Foreign Sales Corporation Act (S. 1804) and Its Application to Webb-Pomerene Corporations and Their Members

Dear Mr. Chairman:

This is to suggest for the record of your hearing that it is important that this bill and its history make it clear that the benefits of this legislation will be available both to Webb-Pomerene corporations and to their members which might choose to sell to Webb-Pomerene corporations through affiliated Foreign Sales Corporations ("FSCs").

As you may know, Webb-Pomerene organizations may be organized as associations or corporations in accordance with the 1918 Webb-Pomerene Export Trade Act. Some forty Webb-Pomerene export organizations are now registered with the Federal Trade Commission.

Both the DISC and the Webb-Pomerene legislation were intended to encourage exports. Thus, it is appropriate that the DISC Handbook for Exporters released by the Treasury Department on January 24, 1972, made it clear that a Webb-Pomerene organization can be a DISC provided it is organized as a corporation. (A copy of the relevant portion of the handbook is attached for your convenience.)

The Honorable Robert J. Dole
Page Two
December 9, 1983

Webb-Pomerene associations and their members have benefited from the DISC legislation, and it is our understanding that the policy of the pending legislation is to substitute FSCs for DISCs. Nevertheless, it is important to assure that this policy is reflected in the technical language of the bill as it would affect Webb-Pomerene corporations.

We would, of course, welcome the opportunity to answer any questions and to confer with your staff regarding technical matters.

Respectfully,

Jerry L. Oppenheimer

JLO/sr
Enclosure

DISC

MADE IN USA
DISC

Domestic International Sales Corporation

a handbook for EXPORTERS

or from unrelated DISCs, or (2) sell on a commission basis for such persons. A DISC can also manage the export activities of unrelated DISCs. Where the best course for a business has been to export through an independent distributor, there is no reason why such an arrangement should not continue. It might be advantageous for the business to organize its own DISC which would in turn export through an independent distributor.

How can a small businessman use a DISC?

A small businessman can use a DISC with a minimum of difficulty even though a DISC must be a corporation. For example, a small manufacturer can with little difficulty organize a DISC with $2,500 of capital and have it act as a commission agent on export sales.

I have never exported before. Can a DISC be of benefit to me?

The Government would like to encourage persons to export who never exported before and DISC should prove helpful in this. There is a minimum of formality required to set up and operate a DISC. The Commerce Department has experts in its National Office and its 42 field offices who are available with advice and information for the new exporter. Commerce will provide information on economic conditions, foreign markets, specific export opportunities, and U.S. Government sponsored commercial exhibitions abroad. Financing for U.S. exports is available through commercial banks and the Export-Import Bank which, along with Commerce, will supply information on export loans, guarantees and insurance. The telephone number of the National Office of the Commerce Department is (area code 202) 967-3181.

Can a group of small producers set up a DISC?

Yes. There are no limitations or requirements as to the number of shareholders, and a DISC can handle the exports of any number of United States producers whether related or unrelated. It is contemplated that in many instances several small producers will arrange among themselves to export through a jointly owned DISC.

Can a Webb-Pomerene Association be a DISC?

Yes, provided it is organized as a corporation. If the association is not in corporate form it may reorganize as a corporation and readily qualify as a DISC. A Webb-Pomerene Association which qualifies as a DISC would have one-half of the Federal income tax on its export earnings deferred and could make "producer's loans" to its member companies or other export producers.

Business necessity requires me to keep my foreign selling organization. Would a DISC be of benefit to me?

Yes; for example, a U.S. producer that has a foreign selling subsidiary or an independent foreign distributor which it intends to keep, will generally find it advantageous to have a DISC to act either as agent or principal on sales to its foreign subsidiary or distributor.

I already have an export department that I intend to maintain. Would a DISC be of benefit to me?

Yes. One of the advantages of also forming a DISC is the simplified allocation method that would be available.

What property can a DISC export?

Property manufactured, produced, grown or extracted in the United States (including Puerto Rico and the possessions of the United States) qualifies for sale through a DISC. At least 50 percent of its value must be attributable to United States content. Components and finished products, agricultural commodities and minerals would be qualified DISC exports. However, property which benefits from certain government export subsidies, or which has been declared by the President to be in short supply in the United States, would not qualify. As yet, no property has been declared to be in short supply for this purpose.

What is an export?

In the case of a sale, the property must be delivered outside of the United States for use outside of the United States. In the case of a lease, the place where the property is used determines whether there is an export.

To whom may a DISC sell?

A DISC may sell to any related or unrelated person where the property is to be delivered outside the United States for use outside the United States. A DISC may also sell and make delivery in the United States to a second DISC for export by the second DISC if the two DISCs are unrelated. Sales to other persons by a DISC for delivery in the United States will qualify only if they are unrelated and it is established that after the sale by the DISC there is no further sale, use or processing within the United States